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AVAILABILITY AND AFFORDABILITY PROBLEMS IN LIABILITY INSURANCE

HEARING

BEFORE THE

SUBCOMMITTEE ON BUSINESS, TRADE, AND TOURISM

OF THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

AVAILABILITY AND AFFORDABILITY PROBLEMS IN LIABILITY INSURANCE

DECEMBER 3, 1985

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AVAILABILITY AND AFFORDABILITY PROBLEMS IN LIABILITY INSURANCE

TUESDAY, DECEMBER 3, 1985

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
SUBCOMMITTEE ON BUSINESS, TRADE, AND TOURISM,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m. in Room SR-253, Russell Senate Office Building, Hon. Larry Pressler [chairman of the subcommittee] presiding.

Staff members assigned to this hearing: Nancy Unger, professional staff member; and Amy Bondurant, minority staff counsel.

OPENING STATEMENT BY SENATOR PRESSLER

Senator PRESSLER. The hearing will come to order. I will make a brief opening Statement and then call on my colleague Senator Rockefeller to make his opening statement, and then we will hear from the witnesses.

This is a hearing on the availability and affordability problems in liability insurance. A major problem has developed recently for people who buy insurance. Professionals, businesses, and governments often cannot find affordable or adequate liability insurance.

Some in the insurance industry State that the problem stems from a civil justice system out of control. Others say the industry brought itself trouble through unwise underwriting practices over the past several years. Still others say that we are simply seeing a downswing in what is very clearly a cyclical industry which will recover on its own in due course.

While the causes may be open to dispute, the effects are all too clear: reducing coverage, unavailable coverage, skyrocketing premiums, mid-term cancellations and policy nonrenewals.

The difficulties of finding affordable liability insurance cut across all sectors of the economy and affect every facet of our lives. We have heard the various horror stories: local governments completely dis-incorporating or suspending essential services such as police protection because they cannot afford insurance; businesses experiencing 200 to 1,000 percent premium increases despite perfect claims records; profes-sionals eliminating services because they cannot find adequate coverage.

This hearing, it turns out, is especially timely for my home State of South Dakota. As of approximately 48 hours ago, the State of South Dakota has been unable to obtain any property, casualty liability insurance.

The State has decided not to self-insure, but has opted instead to invoke its sovereign immunity. In a sense, this is one step beyond going bare, or self-insuring. There may be court challenges to this action, but the bottom line is that some injured parties will have no recourse whatsoever.

I have already received calls from snowplow crews, who are understandably concerned about their personal liability. They are questioning whether they should risk going to work to open blocked roads, for fear of claims being filed against them.

When essential services are being threatened on a Statewide basis, something has to be done. This problem has reached outrageous proportions.

One aspect of this crisis that no one has paid much attention to is its effect on third parties the consumers, taxpayers, and others who rely on services provided by insurance buyers.

If a municipality decides to go bare, it is the taxpayers who will pay the assessment necessary to cover a large judgment. When a bus company decides to abandon routes because its insurance premiums increase 400 percent, as was recently the case in South Dakota, it is the elderly and fixed income residents who lose their only means of transportation. If manufacturers or service industries experience dramatic premium increases, it is the consumers of those products and services who ultimately assume that cost in the form of higher prices.

Today's hearing is the first in a series designed to examine the causes of and potential remedies to the high cost and scarcity of commercial liability insurance. We hope today to gain a better understanding of this issue and begin a thorough discussion of the various solutions being suggested by insurance buyers and sellers. Our task is a complicated one. Not only are the causes of the problem unclear, but the remedies are not readily apparent.

Insurance buyers and sellers alike are calling for tort reform—caps on awards, limits on lawyers' fees, and elimination of punitive damages. Yet, tort reform is only one possible long-term solution that will take time to accomplish, especially if it is done on a State by State basis. We must also examine what can be done now to assist individuals and organizations that cannot find affordable insurance.

The McCarran-Ferguson Act of 1945 delegated to the States regulatory authority over the insurance industry. It did not provide for Federal oversight or guidance. Therefore, the role that the Congress or the Federal Government should play in making insurance more affordable and available is unclear. It has been suggested that we should revisit McCarran-Ferguson and assert a strong Federal role in insurance regulation.

My basic philosophy has always been to leave these kinds of issues to the States, but this problem seems to be transgressing State borders. It appears that rates are no longer set on a State by State basis, and it is unclear to me to what extent they are regulated at all. For example, in my home State of South Dakota insurance rates for cities and counties are skyrocketing despite an excellent claims record.

The only explanation I have heard thus far is that South Dakota buyers are subsidizing claims incurred in other parts of the country. I plan to explore this ratemaking issue in more detail later in the hearing, but if this is really happening, it seems to me that the call for tort reform at the State level loses much of its appeal.

South Dakota in my view already has fairly reasonable tort laws. Indeed, its claims record seems to bear that out. But if rates do not reflect the more favorable laws or claims records, the individual States do not have much incentive to reform tort laws. And I say this as an advocate of tort reform. I am a co-sponsor of the Uniform Product Liability Act and the medical malpractice liability reform legislation.

We have also been unsuccessful in our attempt to obtain from advocates of tort reform any substantial empirical evidence that directly links liability insurance rates to the tort law in particular States. I do not want to sound as though I have any predetermined positions on this issue, but I do want to make our witnesses aware of these concerns so that they can be more fully addressed later.

My sense is that the overall insurance problem is a result of a combination of factors, which include past underwriting practices, tort law problems, and the cyclical nature of the insurance industry. I think, however, that we are far from reaching any kind of consensus on the significance of these different factors set in the overall insurance problem. That is an essential first step before we can begin the task of formulating a solution.

We should not be looking for quick fixes, but we should be looking at the steps State and Federal authorities can take to prevent businesses from closing, municipalities from disincorporating, and professionals from abandoning their professions. We hope that the advice of the witnesses who have joined us today will help develop a clearer idea on how to properly address this complex issue.

In conclusion, let me summarize the problem by saying that I think it is the consumer issue of the 1980's and 1990's, because in the end the consumers are paying the higher costs of insurance which stem from attorneys' fees, defense costs, courrt awards, and so forth. Indeed, I am for a highly developed sense of individual rights in our society, but this problem has reached the stage where it seems to be out of control. Something is wrong and it needs to be fixed. We must begin that job now. That is the purpose of these hearings.

Senator Rockefeller?

OPENING STATEMENT BY SENATOR ROCKEFELLER

Senator ROCKEFELLER. Thank you, Mr. Chairman. I'm very grateful to you for holding these hearings. I understand that the purpose of the hearing today is to focus attention on the high cost and availability of commercial liability insurance, in general. However, this morning I am going to highlight one particularly troubling aspect of the insurance problem that has hit my State of West Virginia and many other States nationwide, and that is the municipal insurance crisis.

In recent months, I have met with a great many West Virginia officials whose municipal and county governments are being plagued by severe insurance problems. Many communities in West Virginia and throughout the country are being forced to pay exorbitant increases in insurance premiums that they cannot afford. Others find it virtually impossible to secure any coverage at all.

Recognizing how widespread the insurance problem was becoming, I wrote to the State's mayors and to the county commissioners, and their responses are still coming into my office. They have been overwhelming, and let me just share a couple of them with you.

In Monongalia County in the northern part of our State, the home of West Virginia University, one official wrote: "Our county transit insurance was cancelled. Two months later we were told that our property liability insurance would not be renewed. In September the insurance carrier chose not to renew our public officials and employee liability insurance. What is particularly troublesome to us is that our county has had an excellent claims record over a number of years. Regardless of our good record, we are in the same boat as other counties."

McDowell County, which is a deep southern county in the West Virginia coal fields, with a lot of unemployment problems, was unable to take possession of 10 new police cruisers from the Ford Motor Company because they were unable to obtain Ford's prerequisite—that is, collision insurance coverage on the cars.

The mayor of Shepherdstown, in the eastern part of our State, wrote: "It seems quite a coincidence that your letter came the same day that we were notified that our police liability policy would not be renewed on January 1st, 1986."

In Jefferson County, the engineer resigned. In Berkeley County, three public service district commissioners resigned due to lack of liability coverage. The resignation of public officials due to fear of potential personal liability is a very unsettling proposition, with fundamental consequences for our democracy.

When liability claims reach past an elected representative's office and into his or her home, it effectively discourages average citizens from actively working to serve their communities in public positions. The strength of the nation is based on these people deciding to serve in public positions.

At the root of all of these stories is the skyrocketing cost and lack of availability of municipal liability insurance coverage. The problem, as the chairman has said, is not limited to West Virginia. Nationwide it is the same. So the dilemma: Do these communities eliminate services be-

cause they cannot afford to insure the officials who provide them? That is one choice.

Or, do they continue to provide services without adequate insurance coverage and run the risk of being sued? Or, in the third part, do they chose neither of those options and, instead, do key officials en bloc or individually, resign?

We will have, Mr. Chairman, as one of our witnesses this morning the mayor of Nitro, WV, who happens to be the president of the Statewide West Virginia Municipal League. You will hear in his testimony some of his personal concerns. He is a man with long experience, an excellent mayor, and you will hear of some of the things that he worries about in terms of his own future.

So in my judgment, our community should not have to make this kind of choice. Some have asked me, and I'm sure they have also asked you, Mr. Chairman, why hold hearings at the Federal level on an industry that is regulated at the State level? Insurance regulation has been by statute and long precedent a State, rather than a Federal concern. So what can Congress do?

My response is that the solution to this problem will not be found at the Federal level exclusively. We will need to work hand in hand with local officials. I doubt any of us have the answers at this point, although perhaps this hearing will produce some.

The point is that the hearing today, Mr. Chairman, is the first one this year in the Senate to comprehensively address the insurance issue, and I do commend you.

I have a Statement from Senator Hollings that he would like to have included in the rcord.

[The Statement follows:]

OPENING STATEMENT BY SENATOR HOLLINGS

Mr. Chairman, today we begin a series of hearings on an issue of critical national importance—the affordability and availability of liability insurance.

Current problems in the insurance industry have become a dilemma for a variety of interests, from local governments to manufacturers, insurers, and consumers. Already in 1985, the Commerce Committee has heard testimony on the inaffordability of liability insurance to a wide range of industries, including satellite and space commercialization, commercial fishing, bus and household goods transportation, and trucking. I am pleased that Chairman Danforth intends to continue with further hearings on this issue in the full Committee early next year.

I suspect that at today's hearing we will see a great many fingers pointing at the current tort system as the root of the insurance problem. This is, to say the least, oversimplifying the issue. The causes of the current problems in the insurance marketplace are complex. Market analysts agree that the industry's woes stem from falling interest rates. Several years ago, insurance companies were often willing to write policies with artificially low premiums beccause the loss could be recovered by investing premiums at high interest rates. In this financial climate, premiums were also forced downward by heavy competition among companies to increase market share. More recently, interest rates have fallen, thus adversely affecting the ratio of premium income to the contingent liabilities.

So I would caution my colleagues against regarding solutions to perceived problems in the tort system is a panacea to the liability insurance issue. Perhaps more importantly, we must ensure that our crusade to increase the availability and affordability of insurrance for businesses does not undermine the positive attributes of our current tort system—specifically, its incentives for product safety.

I look forward to today's testimony and the opportunity to question witnesses.

Senator PRESSLER. Thank you very much, Senator Rockefeller.

It is now an honor to call on the Honorable John E. Porter, U.S. House of Representatives, a good friend. And we welcome you to the committee.

STATEMENT OF HON. JOHN E. PORTER, U.S. REPRESENTATIVE FROM ILLINOIS

Mr. PORTER. Mr. Chairman, thank you very much for the opportunity to testify before this distinguished committee this morning. I would like to start this session by asking: Why are we here, sitting in the Federal legislature, addressing issues of liability insurance? Is this not traditionally a State issue? Does the Federal Government really have any business getting involved in it?

Well, the answer is that insurance issues are State issues, but they are becoming Federal issues because of the changing nature of the tort doctrines of liability that have crept up on us over the years. In addition, there exists a growing public expectation that for every unfortunate occurrence someone must be sued and made to pay. Third, the Federal Government is indirectly paying for some of the costs associated with increased litigation.

The costs of liability judgments are becoming so high and so unpredictable in many areas that the business of insuring against them is no longer attractive. And if insurers do not elect to cancel coverage, they are often forced to charge such high rates that vital services being insured may themselves become uneconomic.

We seem as a society to be in danger of having to put more resources into the negative side of insuring against possible tort recoveries than into the positive side of suplying better municipal services, better medical services, and better designed products.

Let me cite three quick examples. First, a recent study concludes that it will soon become feasible to sue for education malpractice or a defective education. While we may think this is some kind of frivolous litigation, surely it is no more improbable than some of the recent California decisions.

One of those decisions, Mr. Chairman, awarded a large settlement and monthly payments for life to a trespassing vandal who was injured when he fell through a skylight. He was hoping to break into the building.

Imagine the social consequences if education malpractice suits are to be settled with a typical type of generous award that includes economic costs for the victim to buy a new education, compensation for his decreased earning capacity, perhaps an additional award for the pain and suffering inflicted by lack of a good education.

The school system would have to divert funds to pay for the judgment and litigation costs, instead of putting those scarce dollars into more and better teachers, textbooks, and educational resources. The tort approach would have caused a gigantic misallocation of resources from positive to remedial activities. The quality of education would lower as taxapayers' money is drained away from education and into litigation.

In Illinois, in my district, several small municipalities with excellent risk records have not yet found any insurance coverage this year for their paramedics. The risk of lawsuits is simply too great for any insurance company to regard this as a viable business proposition. So what are the consequences?

Some of these villages may eventually have to stop running local medical emergency rescue services. Citizens may die unnecessarily of heart attacks because there may be no CPR-trained paramedic to help them. Relatives of those citizens may eventually try to sue the very same municipalities for lack of prompt emergency services.

In the meantime, many of these municipalities are partially or fully bare against suits. Even a single incident, however, could result in a huge jump in the local tax rates or possibly even in personal judgments against the town's officials. How long can we continue to attract good people to careers in local government or to service on voluntary community boards if these trends continue?

Another example recently highlighted in hearings in the House Committee on Energy and Commerce is the lack of insurance coverage nationwide for nurse-midwives. Midwives have been seen as a lower cost alternative to expensive obstetrical care for those whose alternative might well be no prenatal or neonatal care.

Testimony was given that it would be necessary to charge annual medical malpractice insurance premiums of up to $73,000 per nurse-midwife to provide an actuarially sound basis for insuring them. Currently the total earnings of such nurse-midwives average only about $25,000 per year. Not only is the liability tail wagging the medical care dog in this case, Mr. Chairman, but it has the unfortunate consequences of resulting in poorer quality and more expensive health services. One can safely predict that without nurse-midwives there will be even more mothers and infants, particularly in poor rural areas, with problem pregnancies and deliveries.

I think all of us in this country love and appreciate our strong legal system, which provides redress for those who have been wronged. The legal system protects the rights of each of us and is one of the strongest pillars of our national freedoms.

The tort system itself is indisputably necessary and valuable. The current tort explosion, however, has many unfortunate aspects to it, and that is why we are all here today. We are seeing the bad side effects all over the country in the fields of municipal liability coverage, medical malpractice, and product liability. In each case, durable, economically sound solutions will only come through simultaneously addressing the issues of quality control and cost control.

Quality control is based on accountability. The tort explosion is a negative means of enforcing quality control, a means which often has perverse effects on the quality of life for everyone. We need to balance this backward incentive for quality with positive incentives and goals to improve municipal services, health services, and the products and services provided by business.

In particular, balance must be restored so that unforeseeable, unfortunate outcomes are not penalized disproportionately to the actual negligence or malfeasance involved just because someone has been hurt and a deep pocket can be linked tangentially to the incident. Lots of individual court decisions, however humanitarian, easily add up to terrible social policies when this balance is neglected.

Economic benefits such as lower insurance rates have also been a driving force behind many positive forms of risk management. The force of lower rates, for instance, leads to improved quality of care in medicine. In some cases, Federal legislation may be helpful in giving legal teeth to quality control.

Cost control is important to everyone, but especially to the taxpayers and consumers who ultimately foot the bills. We are in a period when insurance premiums for municipalities are rising 100 to 500 percent per year, often for decreased coverage.

The same is true for doctors and hospitals, especially in high-risk specialties. Many small manufacturing businesses are on the verge of closing and jobs are being lost because they cannot sustain their product liability coverage even if they have risk-free records.

We hear that these escalating costs are linked to cyclical problems in the insurance industry, as well as to increasing frequency and severity of claims. I for one hope that in the other testimony today some of the insurance groups can suggest ways to smooth out this roller coaster. From the legislative side, at both State and Federal levels, we can also help to implement remedies that will make the risks and costs more predictable so that there is a sound actuarial basis for steady and business-like insurance practices in the future.

I would now like to address myself briefly to specific changes that are needed in the fields of municipal liability, medical malpractice, and product liability to get the tort explosion under control.

In the field of municipal liability, the most pressing priorities are: first, to limit the application of joint and several liability in favor of a return to a comparative negligence standard; and second, to cap awards for pain and suffering and other non-economic damages. The standard meant by "duty of care" needs to be more clearly established at appropriate levels for various public activities like the maintenance of streets and sidewalks.

For certain activities involving public service provision, there may even need to be a return to the doctrine of sovereign immunity when assistance is undertaken in good faith. Attention to internal quality control through employee education and better maintenance for safety will also be necessary.

In the field of medical malpractice, similar measures such as caps on non-economic awards should be adopted by the States to improve risk predictability and insurability. These cost management measures should go hand in hand with actions to deter and control questionable behavior by health care providers so that the overall quality of care for consumers is improved.

Better risk management procedures should be encouraged. Alternative systems for expediting settlement of worthy malpractice claims should be protected by law in situations where providers and consumers can agree in advance on non-tort methods of resolving disputes.

On the product liability issue, I think we all applaud the pioneering work of the Senate Committee on Commerce, Science, and Transportation, this committee, which is taking the lead in trying to develop good and balanced national legislation in this critical area of our national economic life.

An immediate need is to explore the potential roles for the Federal Government in encouraging tort reform and other responses to the liability crisis. One possibility is comprehensive Federal legislation such as is being considered for product liability.

Another is Federal guidelines for State action, using either a carrot or a stick, in order to establish minimum standards for State action. The legislation encouraging States to implement a minimum drinking age of 21 is an example of one way this can be done, and perhaps there are other models that should be applied. The coming year will be a critical period for evaluating the effects of State actions on liability issues and for deciding on appropriate Federal actions if any.

Mr. Chairman, I commend you for taking the initiative to confront this complex and controversial issue. I and my colleagues in the House will be watching your hearings with great interest.

Thank you very much, Mr. Chairman, for the opportunity to testify this morning.

Senator PRESSLER. Well, thank you very much.

I guess what we have is a highly developed sense of rights in our society, but it has reached the point where anybody who tries to do anything can be sued. So people have stopped undertaking some very essential activities, is that not correct?

Mr. PORTER. Yes. I think, Mr. Chairman, the prime example of that is the case of manufacturing DPT vaccinations for young people. You recall that earlier this year all but one of the companies in that field dropped out because they could not go forward without some protection from liability lawsuits in order to provide vaccines that children in America need.

And so we see a total breakdown of the entire system when insurance cannot be predicted well enough so that rates can be set that are reasonable and affordable and economic. And I think that is a good example of what happens.

Senator PRESSLER. What we basically are facing is a State issue. Everybody says to me, what are you going to do about this, but everybody is against the Federal Government intruding into State powers.

Mr. PORTER. Well, I think it is, Mr. Chairman, a State issue. The entire system of liability for wrongs has always in our country been under State control, and frankly, I think it ought to remain there.

On the other hand, the Federal Government can give a push. The very fact that you are holding hearings, the very fact that there is Federal legislation under consideration, brings some pressure on the States to take action in these areas.

There has been, as I mentioned in my testimony, Federal legislation that pushes States in the right directions on a number of different issues, most recently in the minimum age for drinking. And I think that that kind of approach may well be needed in this area, because the problem continues and in fact gets worse and worse as time goes on.

Some Federal push to encourage the States to act in this area may be very well necessary, but I would not change the basic system where the States have control over deciding the compensation of victims of wrongs.

Senator PRESSLER. Senator Rockefeller.

Senator ROCKEFELLER. Congressman, you indicated that you favored insurance regulation staying with the State, and I think I probably do also. But it is true that there is a dual kind of regulation for banking and securities.

How does one defend the singular regulatory authority for insurance, as opposed to the dual regulatory authority for banking and securities, for example?

Mr. PORTER. Well, I think that in regard to banking at least, history put the Federal Government into the subject of banking very early in our nation's beginnings. National banks were chartered by Federal legislation very, very early.

Such was not the case with respect to insurance, and so I think that there is an historical difference that probably is one that is well to preserve, and I would hope that any action that we take in the Congress would preserve to the States their rights generally in this area. I would not like to see, for example, some form of national compensation such as a workers compensation system that would be run at the Federal level. I think that would be a mistake.

But I do think that we can push the States in the right direction with well-crafted legislation to give them encouragements to take on this subject.

I think one of the things that is very evident from my own service in the State legislature is that the trial lawyers associations have a great deal of clout in each of our 50 States and probably a great deal more clout over State legislative actions than they do over the Congress and its actions.

And so it may be necessary from a practical standpoint, in order to move States in the direction of tort reforms, to balance the influence that trial lawyers have over State legislative bodies with some Federal pressure to get the job done.

Certainly we cannot continue to drift the way we have drifted as problems in medical malpractice, problems in product liability, and now problems in municipal liability have grown and grown and grown, with really very little having been done over the last decade or so to address them in a meaningful way.

Senator ROCKEFELLER. Thank you, sir.

Mr. PORTER. Thank you very much, Senator.

Senator PRESSLER. I shall now call our first panel forward. I will call: Mr. Frank A. Swain, Chief Counsel for Advocacy, Small Business Administration; Mr. Edward J. Muhl, commissioner, Maryland Department of Insurance; and Mr. William Wyer, president, Delaware State Chamber of Commerce. If they would come forward.

We will first hear from Frank A. Swain. Thank you very much for being here, gentlemen. And Frank, why do you not proceed.

STATEMENTS OF FRANK S. SWAIN, CHIEF COUNSEL FOR ADVOCACY, OFFICE OF ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION; EDWARD J. MUHL, COMMISSIONER, PUBLIC SERVICE COMMISSION, MARYLAND DEPARTMENT OF INSURANCE; AND WILLIAM WYER, PRESIDENT, DELAWARE STATE CHAMBER OF COMMERCE

Mr. SWAIN. Mr. Chairman, I appreciate the interest of you and the committee in holding these hearings this morning. As your statement indicated, this is the first in a set of hearings, and it certainly is comprehensive.

Senator PRESSLER. By the way, we will operate or the 5-minute rule, which usually turns out to be a little bit more. But we are going to put your entire statements in the record, if you can summarize, as Senators do, down to a shorter period of time.

Mr. SWAIN. I will certainly attempt to summarize. I am not sure I will do it as well as Senators.

First of all, I appreciate your invitation to our Office. Small business is certainly very concerned about the insurance issue. I think that, judging from the testimony of Congressman Porter and certainly yours and Senator Rockefeller's statement, it might be fair to say that the insurance crisis is especially a small business, small town issue.

We have certainly heard about it in a tremendous degree over the last several months. As you know, Senator, last year the Congress passed a law that would establish a series of national White House conferences on small business. A conference was held in South Dakota a couple of weeks ago. A conference is coming up I believe 2 weeks from today in West Virginia, and we are working our way around through the several States.

In virtually every one of those conferences, we have heard about the issue of business liability insurance. Last summer we convened a group of trade association people and other small business people to learn "what are the issues of concern to small business?" The usual issues came up: taxes, budget, and so on. Nobody thought about insurance. As soon as we started the first set of White House conferences in the fall, we have heard a lot about insurance from small businesses.

The insurance issues are really of two types. One is the basic issue of availability, which affects some industries in particular more than others: restaurants, medical services, daycare, trucking, and manufac-

turers. I am sure you have heard several examples. Anybody who is involved in any sort of environmental risk has a basic problem of availability. These businesses sometimes cannot buy insurance at any cost whatsoever.

A second and related problem is the problem of affordability for those that can buy insurance. It is sometimes too expensive. These small businesses do not have any particular bargaining leverage with the carriers, because they may be a very small account in a very large field. And small businesses by the very nature of their cash flow have little ability to self-insure or build up higher deductibles, which are the standard business practices that one would take to achieve a lower insurance rate.

So I believe that the current insurance crisis is particularly a small business and small town issue. The result of these increased premiums and scaled-down coverage and total lack of coverage is not only momentary inconvenience for the businesses involved, but ultimately, a decline in the health of the small business community, which means a slowing down of innovation, a slowing down of job generation, and a slowing down of the choice available to consumers because only large companies are left in the marketplace. Small businesses that cannot buy insurance may stop handling certain items or services, which will be a detriment to us all.

The causes, I would certainly agree, are those that you outlined in your opening statement. Clearly, the underwriting cycle has a lot to do with it. I would also agree that there probably is some subsidization of rates by some ratepayers over various lines of business and various geographic areas.

We have heard many complaints of small businesses that have had an excellent claims record that their policies have been terminated, their rates increased dramatically, seemingly based on no particular relationship to their individual claims record.

Another cause of the current crisis is the limited capacity of the insurance industry. We touch on this issue in more detail in our statement.

Perhaps the most significant factor is the explosion of tort system. The potential liability of businesses and insurers in a number of areas has increased because of expanded statutory and judgment liabilities. I do believe that the tort system has been the major factor. It is not something that has been turned on and off, but has been increasing over a period of time in both statutory and judge-made laws. There have been movements away from the standard of proximate cause and fault and the prospective of larger damage judgements in a number of types of cases.

The solutions. I think there are a number of solutions. Small businesses must get smarter about buying insurance—they have to go out, they have to look at risk pooling, they have to take a look at hiring risk managers, which really has not been something that small businesses have done much of in the past. They have to shop around more for coverage.

We think certainly that regulatory reform and tort reform are high up there on the list. But I would very clearly agree that it is especially and traditionally a State issue and we need to look initially at the States for both regulatory reform and tort reform.

As you know, the Office of Advocacy and the SBA have strongly supported the product liability legislation that has been pending before this committee. I think that it would be a good experiment. If we could get that through the Congress and get that working, then maybe we will be a step ahead of the game.

Finally, I should mention that the Attorney General has convened a series of task forces on liability issues, including a task force on the availability of liability insurance. The SBA is working with that task force and we expect that that will contribute to the debate. I am sure that the report of the task force will be transmitted to the committee when it is complete.

Thank you, Mr. Chairman.

[The statement follows:]

STATEMENT OF FRANK S. SWAIN, CHIEF COUNSEL FOR ADVOCACY, OFFICE OF ADVOCACY, SMALL BUSINESS ADMINISTRATION

Mr. Chairman, thank you for providing me with the opportunity to describe the problems small businesses are experiencing in obtaining liability insurance. The Office of Advocacy of the U.S. Small Business Administration was created in 1976 to advocate the interests of small business before the Congress and Federal agencies. I wish to express my appreciation to the subcommittee for its timely inquiry into what is accurately described as the liability insurance "crisis."

During the past few months, an alarming number of small businesses have reporting difficulties in obtaining liability insurance. We are hearing about insurance problems from several different sources. Many of the complaints are being received by the SBA's "Answer Desk," which is a toll free number managed by the Office of Advocacy, offering small businesses information and assistance. Small businesses have been calling in almost daily with insurance problems, and the calls are starting to become familiar: premiums have increased by 50, 100, even 400 and 500 percent, in most instances with lower coverage limits and significantly higher deductibles. More and more new policies are including legal defense costs within the policy's coverage limits and almost all new general liability policies are excluding coverage for sudden and accidental pollution. In addition to higher prices and cutbacks in protection, a number of small businesses report that their policies have been cancelled and that coverage is not available at any price. This is particularly true for many new businesses, virtually all of which are small.

In addition to the phone calls we are receiving, small business insurance problems have been a priority issue at the White House Conference on Small Business being held in each of the 50 states. In 20 of the 21 conferences held to date, liability insurance problems have formed the basis for a recommendation for legislative relief. Many of the recommendations for reform were specifically aimed at achieving a uniform product liability standard. As you know, the Congress has not acted on various proposals for Federal product liability legislation. The Administration and the SBA Office of Advocacy have consistently supported this committee's efforts to develop national product liability standards.

I. THE IMPACT OF THE INSURANCE CRISIS ON SMALL BUSINESS AND THE ECONOMY

First, I would like to put my statement in context by describing the role of small business in the economy. Businesses with less than 100 workers employ approximately 44 precent of the private sector work force. In recent years, small businesses have created more than two thirds of our Nation's new jobs. In addition, small business has produced 2.5 times as many innovations as large business, relative to the number of people employed. The ability of small firms to contribute to the economy is being challenged by the cost and availability of commercial liability insurance.

Small businesses are hit particularly hard when there are shortages of liability insurance. It is difficult for many small businesses operating in competitive environments to pass higher premium costs on to consumers. Because liability insurance is not a luxury item but a necessary expense of doing business, small businesses will have to find some means of paying for insurance. In many cases, this may result in limiting business expansion and reducing payroll and other operating expenses. Most small businesses operate on very modest cash flow and do not enjoy the flexibility of large businesses to dip into profits, raise prices, or shifts costs among various lines of business.

In addition, small businesses may be at a disadvantage in purchasing insurance from carriers. Small businesses purchase less protection and fewer lines of insurance than large businesses and may have less leverage in negotiating favorable insurance rates. Small businesses may also have difficulty obtaining favorable rates because many insurers do not experience-rate premiums for businesses under a certain size. Because it is difficult to generalize small firms' experience, insurers base rates on industry-wide or sub-industry classes. Therefore, even if a small firm can demonstrate a healthy claims history, it may not help the firm to achieve a more affordable premium rate.

Small businesses may also be disadvantaged as consumers of insurance because the administrative costs of insurance policies tend to be relatively fixed. A larger proportion of small business' premiums, therefore, are contributed toward the carrier's administrative expenses. Large business customers, on the other hand, can offer insurance carriers significant premiums for roughly the same amount of administrative expense.

An additional factor that puts small business at a disadvantage in buying insurance is its lack of in-house expertise in purchasing insurance and managing risk.

While in most small businesses the business owner makes insurance decisions along with a host of others, in most large businesses there are "risk managers" on staff, whose sole duty is to purchase insurance and assess and manage risk. Risk managers help to devise and implement procedures to improve safety and quality control. From the insurer's perspective a business is a more attractive customer if it can demonstrate that, to some extent, it has isolated and reduced potential risks.

In addition to small business' difficulties in purchasing commercial insurance policies, small businesses are less able than large businesses to protect themselves by self-insuring or contributing to a group insurance pool. Small businesses generally have less working capital than large firms and, therefore, are less able to set aside reserves to cover claims or to contribute to a group insurance pool.[1] Small business' lesser ability to retain risk also limits its ability to assume high deductibles in conjunction with conventional insurance policies.

Many small businesses that cannot obtain coverage at any price may simply go out of business, particular those businesses that are required by law to carry insurance. Some small businesses will choose to "go bare" and operate without insurance coverage, exposing the business' and, often, personal assets to potential liability claims. For businesses operating without insurance protection it will be particularly difficult to obtain financing through commercial lending institutions. To afford dramatically increased insurance prices, small businesses may divert funds from business expansion plans, producing a significant loss to the economy of jobs, products, services and innovations. This loss includes not only the number of small businesses that contract or fail, but also the number of firms that never start-up because of the cost or unavailability of insurance.

2. SMALL BUSINESS' DIFFICULTIES IN OBTAINING LIABILITY INSURANCE

We have many examples of the breadth and severity of the liability insurance problem for small business.

One of the typical calls we received was from a motel owner in Missouri. After being notified that his insurance policy would not be renewed, he said he was "lucky" to obtain general liability coverage at three times the price. The new policy did not provide coverage for fire and certain other risks. Fearful of his increased exposure to liability, he closed down a portion of the hotel and is now considering going out of business altogether.

Another small business that contacted us was a two-person mechanical contractor firm in Pennsylvania. This partnership maintains and repairs pipelines in oil terminals. This business' insurance was terminated by its carrier, because it was told it presented a "high exposure to risk." The firm had never filed a claim during its 6 years in business and until this year, had very stable premiums. The business further reported that there had been few claims made industry-wide and that industry standards and safety have improved over recent years. This firm will go out of business if it cannot obtain suitable insurance.

A small non-profit bus company formed by 45 parents to deliver their children to private school was told that its insurance policy was being terminated. The company had been paying $1,200 per year in premiums for each of its two buses. After shopping around for a new policy, it was able to find one that offered half the dollar amount of coverage for $6,000 per year for each bus. This represented an increase of 500 percent for half the insurance coverage. The only claims made by the bus company since 1975 were for minor bodywork and repairs. The bus company is uncertain as to its future.

These stories illustrate the problems common to many small businesses: dramatically increased premiums, scaled-down coverage and policy nonrenewals, many of which do not appear to be based on increased underwriting risks. Our discussions with small business trade associations confirm that these trends exist on industry-wide bases.

Small businesses in a broad cross-section of industries are known to be having insurance availability and affordability problems. These businesses include manufacturers, medical and other professionals, grocery stores, hotels, garages, machine repair shops, and even roller skating rinks. Among the most severely affected industries are trucking, day care, restaurants and companies having anything to do with chemicals or hazardous waste. The inability of businesses to obtain policies to cover environmental risks has reached crisis proportions.

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[1] Federal tax rules do not permit businesses to deduct amounts set aside in a pool to cover potential claims. Deductions, however, are permitted for amount actually paid out in losses claimed. Businesses are permitted to deduct premiums paid for conventional insurance policies.

While the insurance crisis is expected to get worse before it gets better, for many small businesses the real crisis is the decision to go out of business or carry on with limited or no insurance coverage. Unfortunately, many of the more responsible, safety-conscious small businesses will choose to go out of business rather than expose themselves or their consumers to risk. Ultimately, the economy will suffer because of small business' exodus from the marketplace.

3. CAUSES OF THE PROBLEM

These are several reasons that experts have offered for the current problems small businesses are experiencing in obtaining liability insurance. First is the cyclical nature of the insurance industry. We are currently experiencing a "hard market" which follows the "soft market" of the past six years.

The "underwriting cycle" apparently occurs as insurance carriers price their policies lower to build volume and then finance losses with income from investments. When the investment income declines and when claims occur above anticipated levels, rates must be increased and risks reassessed. This pricing and risk adjustment usually results in a more stable market for a period of time and more realistically priced insurance products, according to some industry experts. While there may well exist patterns or cycles in insurance pricing, this phenomenon does not fully account for the dramatic situation that many small businesses find themselves in today.

The capacity constraints of the insurance industry also contributes to shortages of liability coverage. The industry generally follows a rule-of-thumb known as the "Kennedy formula" which theorizes that premiums should not exceed surplus by more than 2 to 3 times.[2] Because underwriting losses are partially paid from surplus, the ratio helps to ensure that carriers do not take on too much business in periods when surplus is low. In 1984, many insurance carriers experienced erosions of surplus due to heavy losses and lower investment earnings. As a result, in 1985, many carriers are turning away new business and more carefully selecting those businesses whose policies they wish to retain.

Another source of the current insurance shortage is the unpredictability of the civil justice system. Each state has its own statutory and judge-made tort law which may vary significantly from state to state. The difference in state laws makes it difficult to predict, for example, the potential liability of manufacturers for defective products that may injure persons in several states. Insurance carriers are reticent to underwrite liabilities that they cannot accurately predict. Additionally, judges and juries, increasingly, are awarding damages to an expanding group of plaintiffs for harms that underwriters never intended to be included in insurance policies. Particularly in the areas of environmental hazards and product liability, awards have been very significant and have gone to unanticipated plaintiffs for injuries not contemplated by insurance carriers.

A final factor that is contributing to the current insurance crisis is the shrinking of the reinsurance market. Reinsurance provides insurance for primary insurance carriers by covering losses to primary carriers over a specified amount. If primary carriers cannot obtain reinsurance for certain risks, they will not insure those risks in the first instance. The foreign and domestic reinsurance market is drying up for the same reasons that primary insurance market is contracting: diminished capacity to underwrite risks and the unpredictibility of the judicial system. The result is a shortage of reinsurance at low prices and the discontinuation of certain lines of reinsurance. The reinsurance market is particularly tight for environmental, asbestos, product liability and certain medical risks.

4. SOLUTIONS TO THE INSURANCE CRISIS

There is no single solution to the liability insurance crisis. As the insurance environment is more fully explored, it may become clear that different solutions are needed to remedy different problems. For example, for those risks which insurers view as "unpredictable" and, therefore, "uninsurable," such as medical malpractice, environmental, and certain manufacturing risks, it may be necessary to substantially reform tort laws to achieve stability and greater predictability of risk. A number of states, such as Michigan, for example, are looking at reforming the state civil justice system to make liability judgments more stable and predictable. The Michigan

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[2] While adherence to the Kenny formula does not appear to be a requirement in any state, it does provide state regulators with evidence of an insurance company's ability to pay claims. ("Surplus" is the equivalent of a corporation's "retained earnings" or working capital).

Senate recently passed a 19-bill package that included: (1) a $250,000 cap on recoveries for noneconomic damages, such as pain and suffering, (2) elimination of the "collateral source" rule,[3] (3) a modification of the joint and several liability standard,[4] and (4) a penalty for bringing a frivolous suit. Other states are considering legislation to limit attorneys' fees. The U.S. Supreme Court has recently indicated its approval of a California law that limits attorneys' fees in medical malpractice cases.

For those businesses that are facing higher premiums, but who pose fairly predictable risks, changes in market conditions may be all that is necessary to lower prices and broaden protection. A number of states, however, are considering measures to safeguard small businesses against dramatic swings in price. The State of Florida's Department of Insurance, for example, is developing legislation that would focus on both insurance and pricing and competition in the insurance market. The proposal, which will soon be introduced in the legislature, will establish a "file and use" approval procedure,[5] require participation in a joint underwriting association (JUA) for certain risks,[6] and enable the State to examine the "excess profits" of insurance companies.[7] The proposal would also enable more competition in the insurance market by allowing certain professional businesses to self-insure and purchase insurance groups.

Finally, there may be insurance availability problems that result from Federal statutes, such as the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA or Superfund). To bring insurers and reinsurers back into the pollution liability insurance market, it may be necessary for the Congress to clarify or amend the law's liability standards.

A difficult question in resolving the various liability insurance issues will be defining the respective roles of the Federal and state governments. Because, historically, states have enjoyed responsibility for regulating the insurance industry and establishing tort liability standards, it will be most effective for the states to resolve insurance problems. Beyond the clarification of Federal statutes, it is not clear which insurance problems the Federal Government might appropriately attack.

One potential area of Federal intervention familiar to this committee is a national product liability standard. Another Federal provision currently under consideration is a Federal law authorizing business needing environmental coverage to form risk retention groups to cover potential claims. I am confident that the work of this subcommittee and other Congressional committees looking at the issue will result in a determination of the proper role of the Federal Government in resolving insurance problems.

At the Executive branch level, the Attorney General has established an interagency working group to focus on a number of tort reform issues, including product liability and the availability of liability insurance for businesses. The SBA will assist the working group in defining small business' insurance problems and in recommending appropriate solutions to the present and future insurance crises.

The Office of Advocacy will also continue to work closely with small businesses, trade associations, the states, trial lawyers, and the insurance industry to learn all aspects of the issue and, ultimately, advocate one or several necessary long-term solutions. One area that we will be focusing on is state legislation aimed at tort reform and/or the insurance industry.

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[3] The "collateral source" rule prevents the introduction of evidence during a trial that the injured party has been or will be reimbursed for the injury from another source. The rule's purpose is to prevent juries from being influenced by the fact that the plaintiff has received compensation for the injury from another source.

[4] Where there is more than one party responsible for an injury, "joint and several" liability enables a plaintiff to fully recover from only one of the parties, even if that party is responsible for relatively little of the harm. This standard has resulted in the "deep pockets" theory of recovery; in other words, the party most able to pay ends up paying for the total liability regardless of their proper share of the liability. A "comparative" liability standard, on the other hand, apportions responsiblity to culpable parties only to the extent of their culpability. The proposed legislation in Michigan would apportion liability by a compromise of these two standards.

[5] A "file and use" procedure requires insurance companies to file with the state the rates they intend to charge prior to putting the rates into effect.

[6] A joint underwriting association (JUA) is a type of assigned risk pool whereby the state requires a number of insurance carriers to provide coverage to specified consumers that are experiencing difficulties obtaining policies. The state of Florida already has a JUA for automobile and windstorm insurance.

[7] Under the proposal, the state could examine the profits of insurance companies made on premiums but not investments. If the profits are determined to be "excessive," the profits are returned to policyholders who follow approved risk management procedures. Florida already has an excess profit law for workers' compensation and automobile insurance.

In the short-run, there are some practical steps small businesses who are having difficulties purchasing liability insurance can take. Unfortunately, for some new and small businesses, there may be no immediate solution to the insurance crunch.

Businesses should shop-around for insurance coverage just as they would for any other necessary business product or service. A number of small businesses that initially reported policy cancellations later informed us that they were able to find some coverage, although scaled-down and at a higher cost.

Small businesses should develop records demonstrating their previous claims experience. In addition, they should maintain records of safety procedures and look at ways to improve safety and quality-control. If possible, small businesses should follow the lead of large firms and call in risk management consultants to help ascertain risk and improve safety procedures.

Small businesses should carefully evaluate their insurance needs and be prepared to assume a greater amount of risk. They may be able to negotiate better policy terms if they accept a higher deductible and assume liability for specified risks or events. For those uninsured risks, it is very important for the business to evaluate and improve its safety and quality control.

Another possibility for some small buisnesses is to obtain a policy through a trade association. Some trade associations are able to negotiate policies for their members that may offer lower rates than the businesses could individually obtain. If this is possible, the affordability or availability of an insurance policy may well justify the price of membership in the trade group.

It may also be possible to obtain coverage through a trade association's master or group policy. A problem with purchasing coverage under a master policy exists, however, where the insurance carrier terminates the policy of the group. This recently happened with the master policy held by the American College of Nurse Midwives. For 11 years the trade association sponsored a master policy that provided coverage to 1,400 participants. The association reports that only six percent of the participants had ever been faced with law suits. The average claim made against the policy was $70,000. The insurance carrier's reason for not renewing the policy was because of the lack of reinsurance.

Another problem for small businesses looking toward trade associations for group insurance coverage is that, in many states, no businesses, or only those in certain industries, may purchase insurance in groups. Some states are acting to remove legal impediments to small businesses' use of group insurance policies.

Another potential source of liability insurance for some of the more profitable small businesses is the group insurance pool. Rather than pay premiums to obtain a group insurance policy, the business/members make contributions to the pool which will be used to pay for losses claimed. The major problems of such group insurance pools, however, are the expense and limited solvency of the pool and its members. Just like primary insurance carriers, group pools may have difficulty finding a reinsurer to back up the pool once its limits have been reached. In addition, Federal tax rules do not allow deductions for contributions to a self-insurance or group self-insurance pool.

4. CONCLUSION

There is no single easy way to resolve the current liability insurance crisis. Whether some or all of the current problems prove to be temporary and merely a phase of the insurance industry pricing cycle, the long term issues of how we allocate risk and responsibility in our society should not be overlooked. Many small businesses cannot weather a complete revolution of the "underwriting cycle" and may fall by the wayside before the cycle completes itself or before a solution to crisis is achieved. The subcommittee should continue its inquiry into this important small business issue. I would be happy to answer any questions.

[The following information was subsequently received for the record:]

U.S. SMALL BUSINESS ADMINISTRATION,
OFFICE OF CHIEF COUNSEL FOR ADVOCACY,
Washington, DC, January 28, 1986.

Hon. LARRY PRESSLER,
U.S. Senate, Committee on Commerce, Science, and Transportation, Senate Dirksen Office Building, Washington, DC.

DEAR SENATOR PRESSLER: I am writing in response to your follow-up questions resulting from the December 3, 1985 hearing on the availability and affordability of

liability insurance. I appreciate the opportunity to further assist the subcommittee in its study of this important small business issue.

Your first question concerns the feasibility of self-insurance or insurance pooling for small businesses. While these alternatives can and do provide needed protection to businesses when little is available in the commercial insurance market, these options are not necessarily long-term solutions available to the majority of small businesses needing insurance.

As you suggested in your question, one of the problems with self-insurance and group insurance alternatives is that very few small businesses have sufficient working capital to contribute to funds or pools. A self-insurance reserve requires a business to set aside adequate funds to cover future claims, and an insurance captive or mutual requires capital contributions to establish the company, in addition to ongoing premium costs. In addition, Federal tax rules are not conducive to either of these arrangements, as only premiums paid for conventional policies are deductible. Monies set aside by a business for self-insurance are not deductible. (A self-insured entity, however, can deduct amounts actually paid out in claims).

While there is no certain revenue level at which self-insurance or insurance pooling becomes feasible, I can describe some recent examples of self-insurance and captive formation and the level of reserves set-aside or capitalization required. For example, the city of Hagerstown, Maryland (population 35,000) set aside $1 million to insure itself after its premium for general liability coverage jumped 1600 percent from $22,000 to $360,000. The increased premium was to purchase $500,000 in insurance protection. The city's claims experience totalled approximately $40,000 over the past 3 years. It is not clear how many small businesses with similar claims experience could afford to set aside $1 million of reserves to cover potential claims of this relatively small magnitude.

Recently, some chemical and petrochemical companies formed an insurance pool which requires $2 million in capitalization from each member, with premiums to be based on revenue until claims experience can be established. The captive provides only excess liability coverage, first requiring a firm to have $50 million of basic insurance to obtain $50 million in excess coverage. Clearly, this level of protection is only available to and necessary for a larger firm.

It should be noted, however, that not all captives or mutual companies require this level of capitalization. Since the late 1970s, many physicians have participated in insurance mutuals and, recently, the American College of Nurse-Midwives announced that it is forming a captive. Given an average annual income of $25,000 for nurse-midwives, it is not clear how significant the capitalization requirements will be.

In addition to the costs, one of the major problems with self-insurance and risk-pooling is the difficulty of obtaining necessary reinsurance. The lack of reinsurance available to conventional insurance carriers is a primary reason why businesses cannot obtain insurance policies and are seeking these market alternatives. Without reinsurance or an umbrella policy, the self-insured's or pool's reserves will mark the extent of its protection: the business' underlying assets may be used to satisfy claims beyond the extent of reserves.

Self-insurance and innovative group-insurance alternatives will provide some businesses and cities with needed protection, while putting some competitive pressure on conventional insurance carriers to ease up on prices and availability. It is not clear, however, to what extent self-insurance and insurance captives will persist in the long-run as competition in the conventional insurance market increases and prices begin to decline. Additionally, increasing litigation and damage awards are as much a threat to the long-term solvency of alternative insurance mechanisms as they are to standard commercial insurance rates.

Self-insurance and insurance captives will have obvious administrative and start-up costs. Depending on the total costs, it may be cost-efficient to wait out the current market until it turns in a year or two as some insurance experts are predicting. The long-term ability of insureds to obtain adequate insurance coverage at a stable cost will likely depend upon achieving significant civil justice reforms.

Your second question addresses the role of the Federal and state governments in achieving solutions to the current shortage of liability insurance.

In the short-term, states could help businesses by establishing market assistance plans (MAPs) and joint underwriting associations (JUAs). A MAP is a voluntary organization of insurance carriers within a state which assists businesses in locating difficult-to-obtain insurance policies. While MAPs do not guarantee that a business will obtain coverage, in many instances they can help a consumer to obtain a suitable insurance policy.

A JUA, on the other hand, is a state-mandated program in which carriers of particular insurance lines within a state are required to provide policies to consumers who cannot otherwise obtain insurance. While JUAs do not guarantee coverage at below market rates, they do ensure that businesses obtain needed protection.

In the long-run, both the Federal and state governments can enact legislative reforms to ensure insurance availability and stability in insurance pricing. As discussed in more detail in my testimony, Congress should enact a Federal product liability law and also reexamine the liability standards created by the Comprehensive Environmental Response, Compensation and Liability Act (Superfund or CERCLA). In addition, the Congress could preempt state laws that restrict small business' ability to purchase insurance in groups or form insurance pools. This can be achieved by extending the "Product Liability Risk Retention Act of 1981" to all types of businesses that need to purchase insurance.

At the state level, legislators should consider the need for civil justice reforms including: (1) a limitation on noneconomic damages, such as punitive damages and damages for pain and suffering; (2) modification or elimination of joint and several liability standards; (3) sliding scales to restrict attorneys' contingency fees; (4) elimination of the "collateral source" rule, which prevents the introduction of evidence that a plaintiff has been compensated for an injury from another source; and (5) screening mechanisms to detect and penalize parties who bring frivolous lawsuits. The combination of civil justice reforms with market-based innovations such as MAPs and risk retention groups should help to ease insurance availability and, ultimately, stabilize prices.

Your final question relates to the new commercial general liability form [CGL] approved by the Insurance Services Organization [ISO].

The ISO's new CGL form, among other things, shifts policy coverage from an "occurrence" to a "claims-made" basis. Under an occurrence form, a policyholder is protected against any claims that arise from accidents that occur during the policy period, regardless of when the claim is eventually brought. Under a claims-made policy, on the other hand, a policyholder is protected only against claims that are actually made during the policy term. To recover under a claims-made form, the claim must arise from an occurrence that took place after the retroactive date of the policy, which insurers say will be the date of first claims-made policy with the carrier.

One problem with the claims-made form is its potential to leave gaps in insurance coverage if a business wishes to change carriers. If an insured changes carriers, the retroactive date of the policy will be moved up to the date of the new claims-made policy with the new carrier. Claims that arise from incidents occurring before that date will not be covered under the new policy. To protect against these claims, however, the insured can purchase "tail" coverage from the previous carrier for 200 percent of the original premium. Because of this expense, small businesses, in some cases, may wish to go unprotected for this period of time. The new claims-made form ultimately may have the result of discouraging businesses from shifting carriers because of the expense involved or, in the alternative, the potential gap in insurance protection.

Insurance commissioners should assess the need for the new CGL form for various insurance lines within their state. The new form, supported by the insurance industry, may help to bring insurers back into the marketplace and, ultimately, stabilize insurance prices. Some observers believe that in the long-run widespread use of the claims-made form may put competitive pressure on carriers to broaden the protections of the form. Insurance commissioners should carefully balance the need to restore insurance availability in the state against the potential of the new form to leave businesses and the public unindemnified.

I hope that this information is helpful. Please contact me if I can provide any further assistance.

Yours very truly,

FRANK S. SWAIN,
Chief Counsel for Advocacy.

Senator PRESSLER. Thank you.

I might mention that Senator Kassebaum has submitted a statement for the record.

I also ask unanimous consent to place an editorial from the Mitchell Daily Republic called "Answer needed on insurance crisis" into the record, if there is no objection.

[The statement and article referred to follow:]

OPENING STATEMENT BY SENATOR KASSEBAUM

Mr. Chairman, I appreciate your scheduling this hearing. The problems in the insurance industry are serious and deserve our attention.

For nearly a year I have been receiving letters from Kansans who are concerned about the cost of property, casualty, and other liability insurance. The impact of premium increases has been felt by nearly everyone. Especially urgent is the need of our manufacturing sector. As in other states across the country, Kansas manufacturers are finding it difficult or impossible to afford a responsible level of insurance coverage.

The cost of insurance is one problem which will be addressed today. The flip side of the insurance coin is even more problematic—availability. Some businesses cannot find insurance or are choosing to self-insure because of prohibitive insurance rates. I do not believe this is in society's best interest.

Traditionally, regulation of the insurance industry has been left to the individual state. These hearings are not intended to threaten that tradition. However, as the full Commerce Committee struggles with the issues of product liability reform, liability insurance for motor carriers, automobile safety, and other issues, it is clear that we can benefit from a better understanding of the insurance industry.

Mr. Chairman, insurance underwriting is a complicated and often hard to understand businesses. However, businesses large and small understand the impact of doubling and tripling of premiums, lower coverage, and higher deductibles. These developments mean smaller or nonexistent profits and expose the business to potentially fatal liablity judgments. A simple look at the general aviation and farm equipment manufacturing industries will indicate the dramatic and discouraging impact of insurance costs.

One example is sufficient to underscore the crisis facing many businesses in all of our states. A manufacturing firm in Kansas, with a typical product liability experience, found out about rising insurance premiums the hard way. On July 1, its product liability premiums were increased by 425%. At the same time, its maximum coverage per incident was decreased from $20 million to $2 million, its deductible increasd from $10,000 to $100,000, and it because responsible for all attorneys' fees. This manufacturing firm's total profits for 1984 were less than the amount of the premium increase.

Maybe this situtation is unavoidable, though I doubt it. Congress has a responsibility to review the insurance industry and hear from all interested parties. Small businesses, manufacturing interests, professionals, and local governments cannot continue to absorb insurance costs which seem to grow exponentially. Nor should consumers be asked to rely solely on the self-insurance practices of a business. I look forward to today's testimony in the hope that it can shed light on these problems and offer some solutions.

[From the Mitchell, SD, Daily Republic, Dec. 3, 1985]

ANSWER NEEDED ON INSURANCE CRISIS

The word "crisis" gets thrown around alot these days. Sometimes, its use seems a step in blowing things out of proportion. Other times, people are left grasping for even stronger words.

"Crisis" seems to us to be the proper word to apply to what is quite suddenly going on in the liability insurance business. As we close in on the end of the year, we hear more and more about clients either losing their coverage or having to pay rates that are skyrocketing 300 or 400 percent and more in a single year.

Under the circumstances, we commend South Dakota Sen. Larry Pressler for recognizing the dimensions of the problem and scheduling hearings in Sioux Falls and Rapid City in the next couple of weeks to try to get to the bottom of its effect in South Dakota. The Sioux Falls hearing, according to an announcement sent our way by Pressler last week, will be Dec. 23.

Readers of this newspaper will recall that the Mitchell school district is among the customers caught in this area's insurance crunch. In recent weeks, there has also been coverage of what is happening to bus lines and day care centers and other businesses that, quite suddenly, seem to present insurance carriers with risks that they apparently believe to have been drastically undervalued right up until 1985.

As is so often the case in complex situations, this seems to present a fine opportunity for accepting a lot of bucks by way of bills and passing the buck in terms of who is to blame.

With varying amounts of accuracy, insurance companies claim they have been victimized by overly generous juries in civil court action. Those being insured are fond of citing increasing costs of insurance in raising their rates for their services. Spokesmen within the court system point out that people are put into a lot of risky situations just in living their daily lives.

In all this circular dialogue, a couple of things strike us as clear.

One is that boasts about how will the free enterprise system works in this country have no place in it, because, in this case, the free enterprise system is not working. The public is being deprived of essential services and regulation must do what business people are proving to us that the normal conducting of business cannot.

Secondly, any government that is worth its salt should feel compelled to jump into the middle of this mess and get to the bottom of it with the due speed that its seriousness requires. We are anxious to see what Sen. Pressler can find out.

Senator PRESSLER. Next we will call on Mr. Ed Muhl, commissioner, Maryland Department of Insurance.

Mr. MUHL. Thank you, Mr. Chairman.

My name is Ed Muhl and I am commissioner for the State of Maryland. I am here also representing the National Association of State Insurance Commissioners as a member of that organization and as chairman of one of their major task forces and committees, referred to as the Commercial Property Liability Committee, which is dealing with this very subject through the national association.

And on behalf of the members of the NAIC, we are very appreciative that you invited us to attend and to offer comment. In addition, we are very sensitive, equally sensitive, if you will, to the concerns and problems that you have expressed earlier in your opening statement as to how the availability and affordability is affecting a lot of our citizens throughout the states.

In your opening statement, Senator, you indicated, that some indicate that the fault lies in the underwriting of companies, that some suggest that the fault lies in the tort system. I would suggest to you that I think the fault lies a little bit in both areas, the pendulum, though, swinging and the weight swinging toward the tort system.

We do have a system, in my opinion, that has gone a little crazy. It is sort of swinging to that wide end where it may no longer be beneficial to society as a whole, where at one time we felt very confident that it was, but it may have gone beyond that point where it is beneficial.

But just to give you a quick overview—and I have submitted to you a prepared statement—1984 was the worst year ever in the whole history of insurance as to losses, and 1985 unfortunately is shaping up to be a little worse than 1984.

It has gone beyond, if you will, individual states. It has gone into the international scene, and it has affected a lot of the reinsurance facilities. It has been a very difficult year. We are talking about a lot of companies who are having solvency concerns, who are looking, if you will, at survival because of the unprecedented losses that they have sustained.

But some of this is their fault. Some of this is the industry's fault to the extent that they participated in what is known as cash flow underwriting rather heavily and rather deeply. They were taking advantage of the high interest rates on the short-term investment return, keeping the premiums down, if you will, not pricing their product as it should have been priced, and now that the interest rates have fallen dramatically, are now in a position where there is a lot of ill-priced business on the books and they are taking a rather severe beating.

But some of these factors, though, were uncontrolled factors. Nobody believed that we would ever have a prime interest rate at 21 percent and commercial paper, if you will, going at 14. We have a situation where one of the largest reinsurance facilities, Lloyd's of London, was sort of caught up into this aspect as well as to losses. In addition they had, if you will, in comparison to the U.S. dollar, the British pound was taking a beating, which compounded the problem of the reinsurance facilities, particularly Lloyds.

And then you did have, say, the controlled factors—the over-indulgence, if you will, into the cash flow underwriting. There was an overreaction to a lot of this by the insurance industry. They were in a position where they were concerned about their solvency, because just since the beginning of the year in the State of Maryland I have signed 27 impaired or insolvency notices of companies licensed to do business in Maryland that are no longer allowed to do business because they no longer meet the financial requirements for capital surplus in our state. So they are having some difficulties.

But in some situations, as a result of this threat to survival, there has been somewhat of an overreaction. I guess the prime example that I use is the daycare folks. There was this thought, as a result of the severe losses that have been sustained, that the insurance industry was going to be very concerned as to where they placed their remaining capacity. Do they put it in more at-risk lines or do they put it in more safe lines, traditional lines where at least they stand a chance of making a profit?

And they have been making the decisions and have been for some time now to put it in more traditional lines, the safer and less at-risk lines. And then they see some reactions. I know in my paper in Baltimore, MD, I have seen some of the names of some towns in southern California and New Mexico that I have never heard of before, but they are across the headlines of my newspaper talking about sex and child abuse of the kids.

And then the next thing in the industry in those lines of business, knowing very well that they have a capacity problem to begin with, they have some solvency concerns, they do not want to be in that line of business. They think that is going to be the next wild area, and they have overreacted. There were a large number of cancellations. They just wanted to get out of that business.

We are, through the National Association of Insurance Commissioners, attempting to get the companies—and we have been unsuccessful to this point—not to overreact, but to come back to some semblance of order, particularly say in the areas of day care folks. We

are now in the position where we are finding some insurance for those individuals.

But I suggest to you—and I see I am sort of running out of time—that the insurance regulators take this task very seriously and we are very concerned about it. For the most part, the insurance commissioners throughout the various States have issued regulations and orders that they are not allowing midterm cancellations nor midterm premium increases.

They are adopting regulations requiring 60-day notices for nonrenewals, and they must give reasons. They are requiring 45 days notice on notices of cancellation. They are prohibiting multiple cancellations of insurance contracts by types of coverages, and they're conducting various market conduct examinations to make sure that the companies are in fact doing those things that are proper and within the bounds of the State laws.

There are several answers that are coming about from the various states, one of which is a market assistance program. We have kicked this off in the State of Maryland and a lot of my colleagues are doing the very same things in the other jurisdictions. And then the States are looking at legislatively joint underwriting associations, assigned risk plans, and that sort of thing.

But the major thing, Mr. Chairman, is that we have to change the rules of the game, because the tort system has gone a little crazy.

[The statement follows:]

STATEMENT OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Mr. Chairman, I am Edward Muhl, Commissioner of Insurance for the State of Maryland and Chairman of the Commercial Lines—Property and Liability Committee of the National Association of Insurance Commissioners. I appear today on behalf of the National Association of Insurance Commissioners (NAIC), the association of the chief insurance regulators of the 50 states and the U.S. territories.

Members of the NAIC share this Committee's concern regarding insurance availability and affordability, particularly with respect to commercial liability insurance coverages. At its 1985 summer national meeting in Kansas City, the NAIC presented a forum which gave representatives of consumer groups and the insurance industry an opportunity to present their views on availability. Consumers representing general contractors, licensed beverage dealers and the medical profession discussed the impact on their constituencies of the inability to find affordable commercial liability coverages. The insurers discussed the impact of the United States civil justice system on underwriting, pricing and reserving.

Commissioner Bruce Foudree, President of the NAIC, remarked in keynoting the forum that insurance regulators must take steps to assure that problems in the civil justice system do not destroy the heart of the insurance process, namely underwriting, thereby threatening the solvency of insurers. He noted that the goal of the insurance regulator is to protect policyholders by assuring that their insurance coverage is not jeopardized by the financial failure of their insurers. Insurance regulators are extremely concerned with regard to the ability of insurers to cope with high civil court awards of actual and punitive damages, rising legal costs, prejudgment interest and increasingly adverse appellate court decisions.

The regulators concluded after the Civil Justice Forum, that both short-term and long-term solutions to the problem were crucial. Consequently, the NAIC has continued to coordinate an exchange of information among the states in order to facilitate immediate responses to the availability crisis. Also under consideration are means to address the long-range solutions relating to the civil justice system in the United States today.

As an example, in October of this year, the Western Zone of the National Association of Insurance Commissioners met in special session in Denver, Colorado to address the problems regarding availability and affordability. The regulators identified possible market conduct violations by several insurers operating in the Western Zone states. As a result, market conduct exams for three insurers have been called to specifically address the following concerns: mid-term cancellations, mid-term premium increases, underwriting standards and results, market availability, capacity and reinsurance. These examinations are expected to be the first in a series that will concentrate on similar practices.

Recently, the Executive Committee of the NAIC met with chief executive officers of leading property and casualty insurers as well as the presidents of the property and casualty trade associations. The agenda included discussions of capacity, uninsurability, solvency, and profitability (an agenda very similar to that before this Subcommittee). The regulators have asked the insurers to recommend an action plan outlining solutions to these issues.

At the onset, regulators recognized that the underlying causes of the availability crisis were real and that insurers responses have reflected a determined effort to control unprecedented losses and expenses. There is a recognition, also, that the underlying problems concern the current inability of insurers to predict loss. Regulators have identified the following factors: (1) a judicial environment which makes underwriting extremely difficult, if not impossible; and (2) ineffective underwriting by a number of insurers. The second category includes companies that have ignored sound underwriting practices and opted for cash flow operations or emphasized marketing and investment operations over underwriting.

Concerns that are raised today lie not only with insurer practices but with the judicial and financial environment. The principal concern, however, pertains to immediate relief for current policyholders of commercial liability insurance.

Possible solutions which have been proposed by insurance regulators include:

(1) Various alternatives to deal with abusive mid-term cancellations including regulations prohibiting mid-term cancellations except for stated reasons including nonpayment of premium, fraud, misrepresentation, illegal acts, or an increase or change in the risk that materially affects the risk underwritten.

(2) A need to place limits on the use of credits and unwarranted downward deviations. Some companies have abused the use of credits to reduce rates below justified levels which has caused financial problems.

(3) Prior approval of rates, restrictions on deviations and mandatory bureau rates as possible solutions for achieving greater stability in rates and encouraging more conservative underwriting.

(4) Adoption of regulations (by some states) which require as much as 60 days notice to policyholders prior to nonrenewal of a contract including a requirement that the reasons for nonrenewal be provided to the policyholder.

(5) A requirement that insurers intending to cancel insurance contracts give policyholders up to 45 days prior notice and state the reasons for cancellation.

(6) A prohibition on multiple cancellations of insurance contracts by type of coverage. Insurers engaging in such a practice, if unjustified, could be subject to administrative action.

Another approach has seen market assistance programs initiated in a number of states to provide for exchange of information about available markets. For example, Illinois, Florida and Maryland have, or will shortly, conduct extensive hearings at the state level to determine the nature of the problem in their own jurisdictions and to prepare responses as appropriate. Additionally, the legislators and the governors in numerous jurisdictions have formed special task forces comprised of public and private sector representatives to address this issue.

The prime focus of this discussion is the interest of the insurance consumer, particularly the commercial insured who entered into a contract with an insurer for a specified coverage for a specified time and now finds that the terms and price may have been altered or no coverage is available. When these circumstances surfaced late in 1984, I found myself in the State of Maryland (as well as other regulators) caught in the crossfire. On the one hand, regulators realized that solvency must be maintained in order to protect existing policyholders; on the other hand, regulators were faced with the reality that the key to solvency for some companies seemed to unlock the door to questionable trade practices in the name of "getting well."

In an effort to address the regulators' statutory duty to protect consumers from unfair trade practices, I strictly and vigorously enforced in the State of Maryland (as have regulators in many other states) administrative rules governing nonrenewals and cancellations. Problems have arisen for trucking risks, agricultural risks, day care centers and other long-term liability coverages. In some instances, coverage was cancelled; in other instances, policyholders complained of what they perceived to be excessive premium increases.

We have also identified another area of concern, namely, the withdrawal of the company of a particular classification of insurance coverage, such as day care centers, while maintaining a market share in other lines percenved as being more profitable, i.e., "creaming" of business. I am concerned that recent cancellations and nonrenewals of day care centers were not supported by a proper demonstration of adverse loss experience or underwriting factors pertinent to the individual risk. We are currently investigating this practice of selective line underwriting to see if regulatory action is necessary.

We are aware, as regulators, that in order for certain insurers to remain solvent, for the benefit of all policyholders, some relief was needed from individual risks. Additionally, regulators are aware of the problems with the reinsurance market, and are separately addressing long-term solutions in that area.

Notwithstanding those considerations, however, there are company practices which are not apparently generated by immediate internal financial difficulties. These companies may be using the current market situation to improve their overall book of business at the expense of the consumer. To those companies we offer little solace and will vigorously enforce, in the State of Maryland, as other commissioners are doing, as well, the rules and regulations pertaining to unfair trade practices, mid-term cancellations, nonrenewals and other pertinent statutory provisions.

Many regulators throughout the United States have adopted, during this year, administrative policies similar to the ones I have prescribed for the State of Maryland, which seek to balance the concern for company solvency with fair and just treatment for commercial liability insurance consumers. It is my belief that these state administrative responses have produced the intended immediate results. However, we are faced with problems that cannot be solved solely through administrative actions. Identifying the long-range solutions is a top priority of insurance regulators in the months ahead.

[The following information was subsequently received for the record:]

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS,
Kansas City, MO, February 14, 1986.

Sen. LARRY PRESSLER,
Russell Senate Office Building, Washington, DC.

DEAR SIR: These answers are being submitted in response to questions submitted to Edward Muhl, Insurance Commissioner for the State of Maryland, on behalf of the National Association of Insurance Commissioners [NAIC]. The answers are listed in the order of the questions submitted.

(1) One of the principal functions of state regulation is to regulate for insurer solvency. Regulators require the submission of financial data from all companies and require adequate reserving practices. In the event that a company ignores "sound underwriting practices", the company can be required to increase its reserves. In addition, regulators have broad statutory authority to place insurers under the supervision of the insurance department if circumstances warrant.

(2) The extent to which rate decreases and increases are scrutinized by state regulators depends upon state law. Some states, such as Texas, require substantial scrutiny while other states, such Illinois, have "open rating" laws which minimize requlatory oversight.

(3) While there are many factors which have produced the current crisis in the availability of affordable liability insurance, the unpredictability of the current civil justice system is a major consideration. The NAIC has established a task force for the purpose of conducting a comprehensive study of legal liability as it affects the insurance mechanism.

(4) In regard to the activities of state regulators to help insurance buyers secure affordable coverage, please refer to our testimony. For example, in addition to Market Assistance Plans, state regulators have at their disposal a number of mechanisms, such as the prohibition of mid-term cancellations and non-renewals, to insure fair trade practices on the part of insurers.

(5) In determining whether or not rate increase is appropriate, an insurance regulator has to take into consideration many factors. Foremost among those factors is the necessity for the proposed rate increase and the impact upon consumers. The availability of insurance is a consideration for consumers as well as the price of insurance.

(6) The availability of adequate, reliable reinsurance is essential to the availability of insurance to consumers. One of the major contributing factors to the current unavailability of liability insurance is the shrinking reinsurance market. Many of the factors which contribute to the unavailability of primary insurance contribute to the unavailability of reinsurance, e.g., civil justice uncertainty, long tail exposures, etc.

(7) Attached is a copy of the NAIC Annual Statement. This statement is required to be submitted by each insurer on an annual basis. The form is prepared under the supervision of the NAIC. The information submitted to the states is made available to the NAIC Insurance Regulatory Information System (IRIS). The NAIC is studying whether this information should be required on a more frequent (i.e., quarterly) basis. State regulators verify the accuracy of the information submitted through the examination process.

(8) State laws on rate regulation differ. Some states have "open" rating while others have more strict supervision of rates. State regulators are constantly evaluating and scrutinizing the relative merits of the various systems. The NAIC has no position on whether one form of rating regulation is preferable to another.

Very truly yours,

ROBERT H. MYERS, Jr.,
NAIC Washington Counsel.

Senator PRESSLER. Thank you very much for your summary. Your entire statement will be placed in the record.

Mr. William Wyer, president, Delaware State Chamber of Commerce.

Mr. WYER. Thank you, Mr. Chairman.

I am William C. Wyer, president of the Delaware State Chamber of Commerce, and I am appearing today on behalf of the Chamber of Commerce of the United States, the world's largest federation of companies, chambers of commerce, trade and professional associations. I serve on the Chamber's Government and Regulatory Affairs Committee, which is composed of business persons who are recognized for their expertise in the area of business-government affairs. The committee recommends regulatory policy to the Chamber's board of directors. I am also a member of the U.S. Chamber's Council on Small Business Emergency Task Force on Liability Insurance.

It is a pleasure to appear before you today and the U.S. chamber appreciates this opportunity. Gentlemen, there is a crisis in liability insurance in America today. At the Delaware State Chamber of Commerce, we hear as many four or five complaints a week, and that seems to be growing closer to six or seven since this text was written.

We see members who are in danger of losing their insurance, and we feel that something must be done right away because these small business owners are in peril. Let me cite some of our local problems for you.

In the city of Wilmington, our municipal liability insurance premiums have increased 43 percent with less coverage than last year. Our capital city of Dover has seen liability insurance premiums skyrocket from $52,000 to over $146,000 this year. And the premiums for Rehoboth Beach, well-known in this community, have dramatically increased from $3500 a year to over $21,000 a year.

If these trends continue, curtailment of city services or even going bare are very real possibilities for Delaware communities. The consequences for business, not just in Delaware but around the country, are even more dire. We should each examine this issue by understanding how we would feel if our own automobile policies were cancelled.

A small helicopter manufacturer in Florida is seriously considering moving his manufacturing operations overseas because of the liability problem. A manufacturer of electric wire casing in Minnesota which employs 32 people has seen his liability insurance rates increase a staggering 4,000 percent. If it cannot find insurance at a more reasonable rate, it will cease manufacturing of certain products.

These are not isolated horror stories. A preliminary survey of callers to the U.S. Chamber of Commerce indicates that business in every region of America has experienced extreme hardships. They have in fact been—businesses in America have had to close because of the cost and the dramatic increase in premium payments.

Small businesses are bearing the brunt of the present crisis. They are unable to self-insure. They are unable to set up captives or exercise other options which are available to larger industries.

Perhaps this crisis will ultimately reserve its harshest consequences for the American consumers. When obstetricians withdraw from their profession, it is the quality of health care for all of us which will suffer. And when sporting goods manufacturers go overseas, it is the American worker who will become unemployed.

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There are many underlying causes which have contributed to the present situation, many based on fact, many on assumptions. Judges and juries are oftentimes making inflated awards. Our courts are broadening the theory of strict liability. This means businesses and their insureds can be made to pay for mishaps even if fault cannot be blamed or cannot be proven.

Although other factors may have contributed to the present situation, there is general agreement that the present insurance crunch is merely a manifestation of a greater problem in our judicial system. The number of lawsuits in recent years has increased almost geometrically.

In 1984 there was one private civil lawsuit for every 15 Americans. Not only is the present tort system costly to producers and manufacturers, it is inefficient as well. Studies have shown that lawyers more often than not get over half the dollars which change hands in these cases. In asbestos litigation, of the average $101,000 award or settlement, the lawyers received $62,000.

Notions of strict liability are expanding. Industries are being held to higher standards of care than that of a reasonable man. This is a result of an increased complexity of society and the belief that there is a financial redress for all injuries, regardless of reasonableness.

Overall fault, which has been the underlying principle to recovery of damages in our tort system, is no longer a prerequisite. State of the art defense against liability is waning. It is being replaced by a concept of absolute liability.

The insurance industry is understandably shying away from writing risks that it cannot identify. There is not only a shortage in the availability of insurance. There are significantly increased commercial and professional liability rates, restrictions on coverage, limits, denials, and cancellations of insurances for both businesses and municipalities.

In the short term, there are positive actions that can be taken. Business owners can strategize their own insurance program by adding risk management, by going bare in certain areas, by consolidating brokers, by shopping around. But these are band-aid approaches. For the long term, we need major surgery.

States like Montana and California have placed caps on the amount of punitive damages which may be awarded for pain and suffering. Just 2 weeks ago, the U.S. Supreme Court dismissed a challenge to a California State law that limits the fees lawyers may collect in medical malpractice cases.

Other similar measures should be considered on the State level. Nine States thus far have enacted laws setting limits on the awards in medical malpractice suits. We must also re-emphasize the need for Federal product liability insurance. It is essential that we come to grips with a system that does not promote safety, but does redistribute enormous sums of moneys to attorneys who perpetuate the system.

We should also consider variations on arbitration. Rent-a-judge, mediations, alternate dispute resolution, should be looked at as means to cut back on the cost of the litigation. I have outlined hastily for you certain broad areas where judicial reform is appropriate.

Undoubtedly, if Congress and State legislatures would address these issues it would have a beneficial effect on the ability of insurance to become affordable to both municipalities and to business alike.

Thank you, Mr. Chairman.

[The statement follows:]

STATEMENT OF WILLIAM C. WYER ON BEHALF OF THE CHAMBER OF COMMERCE OF THE UNITED STATES

I am William C. Wyer, President of the Delaware State Chamber of Commerce, Inc., Wilmington, Delaware. I am appearing on behalf of the Chamber of Commerce of the United States, the world's largest federation of business companies, chambers of commerce, and trade and professional associations. I serve on the U.S. Chamber's Government and Regulatory Affairs Committee, which is composed of business persons who are recognized for their expertise in the area of business-government affairs and who recommend policy in this area to the U.S. Chamber's Board of Directors.

The U.S. Chamber appreciates the opportunity to present its views. It is a pleasure for me to be here.

Not long ago, I read a column in the USA Today, by Susan Percy of Atlanta. I would like to share a portion of that with you. There is no better way to express the irony and frustration of today's topic than through this piece of satire.

Ms. Percy writes, "Now that lawsuiting has become a national pastime, here are some people I intend to sue.;

"The Haagen-Dazs ice cream people, who make the chocolate-chocolate chip flavor. I'm suing to recover the $52.45 I paid recently for black wool skirt. After consuming a quart of their ice cream, I discovered the skirt would not zip or button. Haagen-Dazs is clearly negligent; no warning of any such consequences appeared on the carton. I'm asking another $182.50 to cover the cost of the shoes, blouse and sweater that go with the skirt. And of course, $1.5 million for pain and suffering.

"The Atlanta Humane Society. I have adopted three different cats from these people, and each one of them has developed fleas. I'm pretty sure I see a pattern. I'm asking $4,000 for pest control services, veterinarians' fees and professional cleaning. Just $1 million for suffering, since this is a non-profit organization."

While these are humorous and exaggerated examples of our overly litigious society, these antecdotes emphasize a dangerous crisis that is threatening the economic well-being of our country. They underscore the fact that we are faced with a "liability crisis" in America.

The present "crunch" is causing severe hardships on businesses, professions, municipal and local governments.

At the Delaware State Chamber of Commerce, we hear as many as four or five complaints a week from members concerning this emerging crisis. We see this crisis as a dangerous situation which must be dealt with immediately. Delaware cannot afford to wait—we must avoid, for example, a situation like New Jersey, where consumers already are facing record high automobile insurance premiums.

Let me cite just a few of our local problems. In Wilmington, our municipal liability insurance premiums have increased 43%, while receiving less coverage. The capital city of Dover's liability insurance premiums skyrocketed from $52,850 to over $146,232. The premiums for Rehoboth Beach, Delaware have increased dramatically from $3,500 to $21,100. If these trends continue, curtailment of city services or even "going bare" are very real possibilities for these cities.

The consequences for businesses, not just in Delaware, but across the country are even more dire. We each would suffer greater anxiety if our own automobile insurance were cancelled. Yet, a school bus company in Indiana is without insurance—imagine your anxiety if you owned this school bus company and had no insurance. Would any of us continue to operate a business under such circumstances?

Similarly, a small helicopter manufacturer in Florida is considering seriously moving his manufacturing operation overseas because of the liability problem. Also, a manufacturer of electrical wire casing in Minnesota that employs 32 people has seen its liability insurance rates increase a staggering 4000 percent. If it cannot find insurance at more reasonable rates, it, too, will cease the manufacturing of certain products.

These are not isolated horror stories. A preliminary survey of U.S. Chamber members indicates that businesses in every region of the country have experienced extreme hardship. In fact, there have, been business closures due to the dramatic increase in premium payments. Each day, we learn firsthand of another segment of our economy which has been affected by this crisis. There seem to be no boundaries. Perhaps we will not know, until the U.S. Chamber completes a survey of its members, just how many businesses will be affected and what types will be spared the consequences.

Small businesses are bearing the brunt of the present crisis. They are unable to self-insure, set up captives, or exercise other options which are available to larger companies. Neither do they have the bargaining power to strike a more favorable

deal with insurance underwriters. Recognizing this need, the Chamber's Council of Small Business formed an "Emergency Task Force on the Liability Crisis." Acting on their recommendation, the Chamber's Board of Directors has established a Blue Ribbon Action Group to guide Chamber activities in addresssing this crisis. Attached is a summary of other related U.S. Chamber activities.

Perhaps, this crisis will reserve ultimately its harshest consequences for American consumers. When obstetricians withdraw from their profession, it is the quality of health care for all of us which suffers. When sporting goods manufacturers go overseas, it is the American worker who becomes unemployed. And when, as one road construction firm reported to the U.S. Chamber, firms announce price increases primarily to cover rising insurance costs, it is all of us who wil pay more through higher prices.

Many underlying causes have contributed to the present situation—many based on fact, many on assumption. As the sadly humorous column I shared with you points out, everyone is suing. Judges and juries are overly generous to plaintiffs, many times making inflated awards. Courts are broadening the legal doctrine of "strict liability." This means that businesses, professions and their insurers can be made to pay for mishaps, even if fault cannot be proven.

Although other factors may have contributed to the present situation, there is general agreement that the insurance crunch is merely a manifestation of a greater problem in our judicial system. The number of lawsuits in recent years has increased almost geometrically. Most cases are filed in state courts. Between 1978 and 1983, a record 12 million cases were filed. From 1940 to 1982, civil cases in federal courts increased six-fold from 35,000 to 206,000. Federal product liability suits more than doubled from 1978 to 1984. In 1984, there was one private civil lawsuit for every 15 Americans.

As the number of cases filed has increased, the dollar amount of settlements and awards has increased as well. In 1983, there were 360 personal injury cases with awards of $1 million or more—this is 13 times as many as in 1975. The average products liability award has increased from $345,000 to over $1 million in the last 10 years, while the average medical malpractice award approached $950,000 last year.

Not only is the present tort system costly to producers and manufacturers, it is inefficient as well. Studies have shown that lawyers more often than not receive over half the dollars which change hands in these cases. In asbestos litigation, of the average $101,000 award or settlement, lawyers received $62,000.

Aside from the increasing costs of litigation, expanded tort doctrines have held defendant corporations liable for injuries that could not have been foreseen.

The doctrine of strict liability is expanding—and, industries are being held to higher standards of care than that of the "reasonable man." This is a result of the increased complexity of society and the belief that there should be financial redress for all injuries—regardless of "reasonableness."

Let me provide you with an example. An overweight man with a history of coronary disease suffered a heart attack while trying to start a Sears lawn mower. He sued Sears, charging that too much force was required to yank the mower's pull rope. The jury awarded him $1.2 million, plus damages of $550,000.

This notion of "compensation without fault" encourages actions against "unidentified defendants" and "deep pockets defendants" that is, businesses, utilities, cities and counties who often become defendants in lawsuits because they can afford to pay or have insurance rather than because they are at fault.

Like Band-Aids, such stop gap efforts only will give temporary relief. But, for long-term relief, major surgery may be in order. Some states, such as Montana and California, already have placed caps on the amount of punitive damages which may be awarded for pain and suffering. Nine states thus far have enacted laws setting limits on awards in medical malpractice suits. And, just two weeks ago, the United States Supreme Court dismissed a challenge to a California state law that limits the fees lawyers may collect in medical malpractice cases. Similar measures should be considered on the state level.

Overall, "fault"—which historically has been the prerequisite to recovery of damages in the tort system—is no longer a prerequisite. More and more often, courts and juries have been permitted to speculate how the redesign of a product or the use of a substitute material might have prevented harm or injury to a plaintiff. Unfortunately, these fact finders often fail to consider how this "second-guessing" poses potentially, more serious threats to the consuming public.

The first successful suit against the Sabin polio vaccine was in 1968. The court reasoned that the alternative Salk vaccine should have been used, even though the great majority of medical authorities had concluded that it was the combination of

both vaccines which had very nearly eliminated polio in the United States. The effect of this second-guessing on innovation is too apparent.

State-of-the-art defenses against liability are waning—being replaced by a concept of "absolute liability." These unexpected liabilities, as well as other losses, threaten the ability of insurance underwriters to provide the coverage needed in all lines of insurance. The insurance industry understandably is shying away from underwriting risks that it cannot identify.

As a result, liability insurance shortages are occurring everywhere—from the highly publicized medical malpractice insurance problems of physicians, to the lack of liability coverage for municipalities, to the small business owner who is being forced to "go bare" or to go bankrupt.

There is not only a shortage in the availability of liability insurance, but also significantly increased commercial and professional liability insurance rates, restrictions in coverage, denials or cancellations of liability insurance.

In 1984, insurance companies paid out $1.18 in losses for every $1.00 paid in insurance premiums. In 1984, property and casualty insurers had $21 billion in underwriting losses and $3.8 billion in net losses—the first net losses since 1906, the year of the San Francisco earthquake.

And, there is not much hope on the horizon—indications now are that demand for coverage in 1985 will exceed the insurance industry's capacity to provide by $7 billion. The shortfall may go as high as $62 billion by 1987, according to some experts.

Present troubles also have been exacerbated by practices within the industry. Fierce competition in the late 1970s led to the issuance of imprudent policies at rock bottom premiums. When interest rates were high, premiums were invested. But, in 1984, interest rates collapsed, just as underwriting losses swelled.

Also, insurance regulators do not like insurance companies to write additional business if the ratio of premiums to surplus funds needed to satisfy claims exceeds three to one. This causes an insurer to abandon some clients to reserve its capacity for its best risks—and thus, an availability shortage is created.

Because of recent premium increases, more selective underwriting, and some coverage limitations, insurance companies are anticipating improvements. But, the market will remain very tight until fundamental and far-reaching changes are made.

In the short run, there are positive actions that can be taken. The business owner can reassess his current insurance coverage—considering higher deductibles, "going bare" in certain areas and improving his risk management. The small business owner also can consolidate brokerage, maintain a good underwriter, or "shop around." In addition, he can consider buying insurance through a trade or professional association or by joining a cooperative.

For example, under current Delaware law, (Delaware Code Title 18, § 6865), there are limits on the contingency fees lawyers may receive in medical malpractice cases. Under this section of the statute.

(a) The amount of the claimant's attorney's fees may not exceed the amounts in the following schedule:

(1) 35 percent of the first $100,000 of damages;

(2) 25 percent of the next $100,000 of damages;

(3) 10 percent of the balance of any awarded damages.

We also must reemphasize the need to enact federal product liability legislation. With the present patchwork of laws, it is impossible for manufacturers and retailers to comply with the conflicting standards which the states impose. One uniform federal product liability law would end our "lottery system of justice," where a plaintiff may recover an enormous sum for damages in one state while a similar claimant in another state receives no compensation. It is essential that we come to grips with a system which does not promote safety, but instead redistributes enormous sums of money to attorneys who perpetuate this system.

Also, in the area of environmental liability, the federal government has expanded significantly its regulation of business activities for the purposted purpose of environmental protection. However, these laws and regulations have given rise to protracted and costly litigation. For example, under current law, superfund liability is retroactive and open-ended.

We must search for "reforms" sufficient to reverse the trend of increasing litigation and to solve the pressing liability problems which were not anticipated.

We must consider the many variations on "alternative dispute resolution"—arbitration, "rent-a-judge," mediation—all methods that seek to avoid crowded court dockets, higher legal fees, and liability premiums.

"Alternative dispute resolution" has become increasingly more popular. Nine states currently use arbitration for resolving disputes. However, more law schools

need to offer courses on alternative dispute resolution as the University of Delaware Law School is doing in my home state.

I have outlined certain broad areas where judicial reforms is appropriate. Undoubtedly, if Congress and the state legislatures would address these issues, it would have a positive effect on the ability of businesses to obtain insurance and/or obtain insurance at affordable rates.

This is not to imply, however, that other remedies should not be explored. We must depend on state regulations to guarantee that insurance policies are fair, and to soften the harsh cyclical nature of the insurance underwriting business, without imposing undue burdens on the insurance industry. Similarly, we must make efforts to assist the underwriters in identifying groups which may be covered appropriately on a group basis. Finally, we must assist business in its time of great need, to expand its search for insurance coverage, at affordable rates.

Thank you for the consideration of our views—I will be happy to respond to any questions.

[The following information was subsequently received for the record:]

U.S. CHAMBER OF COMMERCE,
March 13, 1986.

Hon. LARRY PRESSLER,
Chairman, Business, Trade and Tourism Subcommittee, Senate Commerce Committee, U.S. Senate, Washington, DC.

DEAR SENATOR PRESSLER: Thank you for extending to me the opportunity to make additional comments to my testimony of December 3, 1985 on the hearing on "liability insurance." My comments below represent answers to the questions you submitted to me in your letter of January 13, 1986.

Question. Has it been your experience that the drastic premium increases faced by businesses usually reflect past claims records?

1. It has been my understanding that the drastic premium increases faced by various businesses primarily reflect an increase in *exposure* to liability. Although past claims records are important factors in the consideration of liability insurance rates, this is merely one component used to determine the total risk. Since insurance represents the concept of risk spreading and premiums are determined actuarially, the premium rate which mirrors the risk of liability also must take into account such factors as the exposure to risk of all of those who are insured who operate under similar conditions and circumstances.

Question. To what extent are firms going out of business or not providing products or services because they cannot secure adequate or affordable insurance?

2. It is difficult to determine to what extent businesses are not providing products or services because they cannot secure affordable insurance. However, important information has been gathered by the U.S. Chamber's "Business Liability Survey."

According to survey data received so far, 25% of businesses who responded have been forced to drop products and/or services as a result of high premiums and unavailability of coverage. Our statistics have also shown that 13% of businesses surveyed have gone out of business due to the liability crisis.

More striking yet are the results on an industry-by-industry basis. Thirty percent of the transportation industry say they have dropped products and/or services due to difficulties in obtaining insurance. The manufacturing industry has seen 19% of its businesses drop products. Twenty-seven percent of the construction and contractors are dropping products and services. Finally, 26% of the machine sales and service industry are dropping products and services.

Question. Does the chamber have a breakdown on what types of organizations or businesses were subject to those $360 million plus awards in 1983?

How many of those awards were appealed, or is that $360 million a post-appeal figure?

3. Although the Chamber does not have a breakdown on what types of organizations were subject to million-dollar plus awards in 1983, related data provides excellent insight into the trends of these high awards. First, the Institute for Civil Justice Reform reports that 1st verdict large jury awards have more than doubled in the 1970's as opposed to small jury awards which have remained much more stable over the same period of time. Second, the difference in trends seems to be due in part because juries made bigger awards against "deep pocket" defendants—businesses, professionals and government agencies—who usually the defendants in product liability lawsuits. Their study shows that government or business defendants

were assessed 30 to 50 percent more than individual defendants to plaintiffs with similar injuries in the same type of lawsuits.

Question. What has been the effect of what you refer to as "judicial second-guessing" on manufacturing innovation?

4. The effect of judicial "second-guessing" on manufacturing has been to reduce the incentive of manufacturers to produce new products or provide new services. As judges attempt to weigh the difficult trade-offs of risk and benefit when determining whether design defects exist, they often increase the product faced by society.

One of the most striking examples is in the area of vaccine production. When considering mass immunization against disease, virtually all medical experts agree that public health favors vaccination. But developing liability law threatens the production of both existing and future vaccines.

Question. What is the chamber's reaction to the ISO's new commercial general liability policy which is currently being presented to the various state insurance commissions?

5. It is still somewhat early to guage reaction to the ISO's new commercial liability policy. The most controversial change involves the switch from "occurrence" based coverage to a "claims-made" based coverage. Under the claims-made format, the policy coverage is triggered when a written claim is made. This is in contrast to the occurrence form in which the date of the damage or injury triggers coverage whether or not a claim is made at the time. Reaction by business probably will not be favorable as the policy overall represents a restriction in liability coverage. It is important to note that the change in policy form is a recognition by the insurance industry that assessment of risk has become increasingly difficult.

Question. In your testimony, you indicated that Delaware law limits contingency fees for medical malpractice damage awards. Do you know if insurance premiums have decreased in that line since the enactment of those caps?

6. There is presently no data available of which I am aware which demonstrates the effect that Delaware's liability laws have had on insurance premiums.

I hope the information I have provided is useful. Please do not hesitate to call me or Barry Bauman at the U.S. Chamber of Commerce at 202/463-5500 if we can assist you further. Again thank you for permitting us to express our views on this very important topic.

Sincerely,

WILLIAM WYER,
President, Delaware State Chamber of Commerce.

Mr. WYER. I agree, absolutely.

Senator PRESSLER. Does the SBA feel there is a need for a Federal insurance or reinsurance program that would serve as a short-term remedy to the unavailability problem in certain lines?

Mr. SWAIN. In a nutshell, Senator, no. I do not think that the SBA feels that setting up a Federal program to remedy some perceived defect in the private markets is ever a very cost effective or practically effective way of going about things.

There may be some necessary reforms. There may be some management training. There may be a number of steps that we can take. But to set up a Federal bureaucracy to get involved somehow in the business part of selling or reselling insurance is probably not the best idea.

Senator PRESSLER. Given that many cancellations, nonrenewals, and premium increases have no bearing to a firm's past claims record, is risk management truly successful in lowering premiums and deductibles for small business?

Mr. MUHL. I think it is, Senator, to a large degree. But I suggest to you that when you have a group of individuals, let us say municipalities, take them as a group, when you have a classification and you have a relatively large number of these, the whole concept of insurance is the law of large numbers.

You are going to have certain good risks compensating for the bad risks. And when you have the classifications, whether it is municipalities or whether you talk about auto liability or whatever, you are going to have a sharing and a spreading of that risk and a spreading of the cost.

Senator PRESSLER. You have heard me mention that South Dakota has decided to forego any property casualty liability insurance and invoke sovereign immunity. Are you aware of any other States or governments that have done this, and is it something we should expect to see more of in the future?

And I guess I would address that to Mr. Muhl.

Mr. MUHL. Yes, there is an attempt, I think, in a lot of jurisdictions to invoke the sovereign immunity. Unfortunately, there have been numerous court decisions over the years that have eroded that sovereign immunity, that immunity, if you will, for the various jurisdictions. And there is a tremendous concern and a fear by the municipalities and the counties, if you will, in the various jurisdictions that, even if they invoke the sovereign immunity, some court decision is going to overturn it and they are going to be sitting there bare.

Senator PRESSLER. Would you please discuss the ratemaking process in the various states. How does the insurance commissioner's authority to regulate insurance industry activity vary among the states?

Mr. MUHL. There are approximately half of the states, in fact just a little bit more than half, that have what is known as a competitive rating forum, an open competition forum, under the logic and the theory that competition will be a better regulator of rates than, if you will, under a prior approval mechanism, where the individual insurance departments would in fact look at all of the t's and the i's and making sure everything is in place.

We have a competitive rating forum in the State of Maryland and it has worked relatively well for us over the short period of time that it has been in effect. Now, as to rates—and I guess one of the concerns is that in those States where you have an open competition forum that rates have gone up dramatically.

Well, rates have gone up dramatically whether you are in an open competition forum or under a prior approval mechanism. Those are the two major areas, under prior approval and open competition.

Senator PRESSLER. In your statement you talked about premium insurers abandoning unpredictable or unprofitable lines while maintaining service in other lines. How do the commissioners respond to that practice? Do they have the authority to require insurers to write coverage in unprofitable lines? Should they be forced to write coverage for unprofitable lines?

Mr. MUHL. No, for the most part the individual State jurisdictions do not have authority to force companies to write in certain jurisdictions or to write, if you will, certain lines of coverages. I guess the difficulty comes in and the comparison that you could draw is that you could not ask or should not ask a ma and pa grocery store, for an example, to sell their bread and their milk and their items for less than what it costs them.

I guess you can draw the same analogy, if you will, to that of the insurance industry. It is very difficult to force an insurance industry to write certain products where it is not profitable or they are going to be in a position where they are really going to be taking a bath if they do write that particular risk.

Senator PRESSLER. I guess one question further is that, even if some State have a practice of lower claims, either through less accidents or luck or because their juries give lower awards or for good risk management practices, their rates seem to be the same as States that have poor claims records. That is, there does not seem to be any reward. And I guess I am talking about my state. We take a more conservative view—let us take that word not in the political sense—regarding court awards and so forth. Yet the rates are just as high even though there are not as many claims.

Is that fair to certain states?

Mr. MUHL. It is not fair, Senator, if it is the State of South Dakota was picking up, if you will, the losses of the State of Maryland and other areas. But these rates are being charged for the most part, say, on an individual State level.

The difficulty comes in is, when an insurance company proposes a particular rate or premium for a product they are guessing in the future. They are guessing from this point forward what a reasonable cost or a reasonable value for their product is, anticipating certain losses to happen.

When you are dealing with municipalities, it is very sad and very difficult in some situations where an insurance company finds it almost impossible to price certain of those products. In South Dakota, if the municipalities have, if you will, the dump sites, lord only knows what is

in some of those dump sites, and if that is the responsibility of the municipality and if they are ultimately insured, they if something happens to the general water supply as a result of some hazardous substances being put in and dumped into that dump site, it ultimately comes back to be the responsibility of that municipality and whoever the insurer is on the hook.

And there are a lot of individual jurisdictions that are now having that fear, having that concern, and the insurance companies just do not want to be there when the axe falls.

Senator PRESSLER. I would like to address this to Mr. Wyer if I could. Isn't insurance available to every business that wants it, assuming the business is willing to pay the necessary price?

If it is not available, what can or should we do on a Federal level in the short run to be sure that every legitimate business is adequately covered at a reasonable price?

I might add, Lloyd's of London was mentioned earlier. I understand Lloyd's is not going to be doing certain types of reinsurance that they have done in the past, that they are getting more hesitant to do it.

Mr. WYER. Well, to answer your last part first, Senator, when you use the word "reasonableness," I guess it comes relative to what you have been paying and what you might be paying. So that is hard for anyone to assume. But I would say that most businesses are able, through shopping around and negotiating, to get insurance right now.

I would say to you on a Federal level, if you look at toxic cleanups, if you look at asbestos removal, some look should be taken at indemnifying contractors who are doing that work. As you know, right now it is almost impossible to get insurance for moving chemical wastes or pollution, and I am sure that the industry spokesmen who are here will be able to help you better than I can on that subject.

But there are certain areas where no one is writing insurance today, and some of those areas are because the Congress has mandated that we do necessary cleanups of our environment and our public buildings. So you might look at that later in your testimony.

I would say that the issue is just emerging. It has come from emerging to crisis. With the phone calls that you were mentioning, Senator Pressler, from your home town, and Senator Rockefeller, from yours, you are hearing now from the municipalities. You are going to hear from the businesses as their premiums start to come up and when you see the renegotiation of contracts coming forward less than 30 days with many businesses throughout the country.

So you are going to start hearing what is now a whisper become a scream very soon.

Senator PRESSLER. Mr. Swain, do you think that small businesses should be permitted to deduct the amounts they set aside to cover potential claims? Since Federal tax rules do not permit this deduction, do you think this is the way the Federal Government should be involved?

Mr. SWAIN. Well, I think it certainly bears looking into. I am not here as an expert on revenue loss. I am sure the IRS or the joint committee would forecast from such a provision.

But the fact remains that if you go to an insurance expert and say, how can I reduce my premiums or obtain coverage at all, the first thing he will say is to increase your deductible. Well, there is no tax advantage for the small firm to set aside funds in some kind of trust account. The funds are taxed as income like any other item of income would be I think that the issue bears looking into, that, with certain restrictions, is something that we might want to take a look at as a possibility.

Senator PRESSLER. Senator Rockefeller.

Senator ROCKEFELLER. Thank you, Mr. Chairman.

Mr. Wyer, when the product liability bill came up last before this committee I voted against it because I felt that it was not a good bill. But I will have to say that, in the course of the last year I have begun to consider whether I ought to look at some kind of a compromise effort on product liability.

I am not sure that I will change my mind. But the reason I say that I will reexamine this issue is that there has been the most extraordinary outpouring of concern expressed by businessmen in the last period year.

Two years ago, when I was Governor of West Virginia, I was not approached on a routine basis by businesses, nor was I approached by public officials, county officials, municipal officials, with very severe, descriptions of their liability insurance problems.

Now I am getting a lot of phone calls. Every time I go back to West Virginia, there are businessmen, large and small, who are coming up to me in genuine concern. It is a real sense of panic, and I am talking about some very substantial industries, as well as the smaller ones.

This understandably and properly has caught my attention. My question is can you show in national figures what the impact of rising insurance rates really has been on business? People in the business sector are constantly saying I cannot make it, I cannot do this any more, I cannot those premiums. It has gone too high. It has doubled. It has tripled.

But the next step is that businesses would either curtail their activities substantially, or go out of business, is not yet clear to me. I need to know with respect to your State and also with respect to the national situation if you can tell me what those figures are. Are small businesses in fact really going out of business and at what numbers?

Mr. WYER. Well, that is hard to get a handle on. There are small businesses going out of business because of the cost of insurance, and we will send those over to you from the U.S. Chamber, because we have them documented. We are finding the problem is down to predicting your cost as a business, just as it is getting down to predicting the cost of case for an insurance carrier.

We have seen industries have to get rid of product lines in Delaware because of the cost associated with the liability of those lines. There are many national examples which I am sure you have read some, Senator,

sporting wear manufacturers who have been sued in high school suits of injuries happening that have basically been run out of business in the United States. The vaccine example that the Congressman used earlier today.

As you say, there are more and more each day. We are finding a frightening thing are the small businesses who are going bare because they cannot afford to buy insurance, and we do not know what is going to happen to them if anyone brings a suit against them. We are finding it more and more in the family-owned, mother and father, ma and pa businesses of our community that they are willing to take that risk, and I think that is very dangerous for them.

Senator ROCKEFELLER. Mr. Swain mentioned in his testimony that larger companies have the risk managers who specialize in liability insurance and, therefore, these companies can be more astute. Smaller companies cannot do that. They do not have risk managers, and therefore they are winging it a bit more. Do you find that the absence of a risk manager, in a small business can make the difference between being able to get insurance or not?

Mr. WYER. Well, I do not think it makes a difference right now in getting or not getting it. I think it makes a difference now in how you rate it. I think you have seen examples of homeowners insurance which tell us now if we put in a smoke alarm and put in an antiburglar device that they will give us lower rates.

That is an example of risk management. You take that on to the small business owner, the manufacturer. Yes, it is going to have a benefit, but I do not think it is going to keep the cost down at the present time because of predictability. It will help some.

Senator ROCKEFELLER. Are you aware in Delaware of any public officials, major, minor, or in between, who have quit or are thinking of doing so because of the personal liability problem?

Mr. WYER. Not yet. We are aware of two cities that want to test the sovereign immunity doctrine as soon as they get the chance, but they are going to keep their insurance intact while they are doing that, but we are aware of many business people who are questioning whether they are going to serve on nonprofits board of directors in the future if they do not have directors' and officers' liability. We have seen the 52 United Way agencies in Delaware have a very difficult time getting directors' and officers' liability, and the business people are saying I am not going to serve without it, so we think that is pretty dangerous, too.

Senator ROCKEFELLER. Mr. Muhl, are you aware in the State of Maryland of public officials, volunteers who serve on parks and recreation commissions, either elected or nonelected, who have either quit or are considering resigning?

Mr. MUHL. Yes, I am aware, and I think you will have somebody on one of your subsequent panels to testify as well from the State of Maryland. The mayor of Cheverly, MD. And you have an individual here from the Maryland Municipal League.

We had an individual both as mayor and his board resign recently in the city of Sikesville, MD. We have others who are indicating that they are going to withdraw from that capacity as well because in most instances in the smaller municipalities it is either nonpay or just a token payment to take care of the telephone bill, if you will, that they serve, and they are really not willing to put their personal assets at risk.

It is happening as well with our united charity funds. We just cannot get a lot of businessmen, a lot of business people to serve on those committees, to serve on those very important—and to take those very important tasks on without the necessary insurance, and it is very nearly impossible to get it, so we are having a problem.

Senator ROCKEFELLER. Thank you.

Thank you, Mr. Chairman.

Senator PRESSLER. Thank you.

Senator Danforth has arrived. We will call on you.

OPENING STATEMENT BY THE CHAIRMAN

The CHAIRMAN. Mr. Chairman, thank you very much. I do not have any questions. I would like to make the comment, I would like to compliment you, Mr. Chairman, on holding this hearing. I do not think there is any more important subject matter before the Commerce Committee than the whole issue of the cost and the availability of insurance, and the underlying problem of tort reform and liability for injuries.

Every place I go I hear from people who are concerned with this issue. We had a hearing, the Surface Transportation Subcommittee, some weeks ago on the question of truck deregulation.

It turned out that the people who represented trucking companies who were present really wanted to talk more about their problems with being able to buy liability insurance. We have been proceeding in the Consumer Subcommittee on the issue of product liability. That is an old issue in the Commerce Committee. It has been one that Senator Kasten and others have been working on very diligently.

There have been negotiations now to try to work out differences in product liability, and we hope in a reasonable period of time, maybe even between now and Christmas, to have a hearing on the subject of product liability, to keep that ball rolling.

It would also be my hope that some time in the early part of the beginning of next year we could have some full committee hearings on the overall question of the availability and the cost of insurance and tort reform in general.

I think that it is an enormously important issue, and Mr. Chairman, I compliment you on getting into this question, and I would simply say to anybody who is present today, and I know—the fact that there are so many people here indicates that there is great concern. I hope you will be willing to help the Commerce Committee over the long haul, because we are going to be paying very careful attention to this concern.

I am not sure we will be able to just punch a button and have everything turn out okay, because obviously the solutions are going to be somewhat contentious, but it is certainly important. I cannot count the number of people who have come up to me, people who have been in businesses of one kind or another who have said, I cannot buy insurance, I cannot buy insurance, I cannot continue business without insurance.

So it is a matter of great urgency, I think, and great concern to the Commerce Committee, and something that we should welcome the attention and the concern of all interested parties who are here today and anyone else who is interested as we proceed on this issue.

Thank you, Mr. Chairman.

Senator ROCKEFELLER. Could I make a comment to Chairman Danforth? I think all of us have a lot of hearings or public forums. We go back to our different counties and people come in and they bring up problems. A year ago I would have an occasional businessman come up to me and say something about his insurance problems.

Doctors have been facing insurance difficuties for several years. The pediatrician who took care of my four children recently got out of medicine, not entirely because of liability insurance, but it was on his mind,. The phenomenon to me is that in this last year I have not had a town meeting, and I have them all the time, where there has not been a public person, a mayor, a parks and recreations commissioner, a policeman, a police chief, one of these people just basic to our system of government, who have not come to the town meetings for the purpose of making the point that they cannot get insurnace for themselves, they cannot get it for their city, and they are genuinely afraid. These are people who are interested in public service, they mostly come from very small communities, they do it at virtually no salary, but now they are rethinking it. I think it is scary, and I would agree with you, Chairman Danforth, that I think it may be the most fundamental issue for the Commerce Committee.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Rockefeller and Senator Pressler, thank you for getting us started in this area.

Senator PRESSLER. Thank you very much, Mr. Chairman. In the interest of time, I will call our second panel forward, Mr. J. Robert Hunter, president, National Insurance Consumer Organization, Ms. Mavis Walters, senior vice president, Insurance Services Office, Mr. James L. Kimble, senior counsel, Federal affairs, American Insurance Association, Ms. Mindy Pollack, assistant general counsel, Reinsurance Association of America.

I will call on Mr. Hunter first for his statement. And with a look to the clock, we must limit the statements to 5 minutes, but we will place the entire statements in the record. If the room could be in order, and if conversations could be carried on outside the room, it will help us move along. So at this point we will hear from Mr. J. Robert Hunter, president, National Insurance Consumer Organization.

STATEMENTS OF J. ROBERT HUNTER, PRESIDENT, NATIONAL INSURANCE CONSUMER ORGANIZATION; MAVIS WALTERS, SENIOR VICE PRESIDENT, INSURANCE SERVICES OFFICE, INC.; JAMES L. KIMBLE, SENIOR COUNSEL, FEDERAL AFFAIRS, AMERICAN INSURANCE ASSOCIATION; AND MINDY POLLACK, ASSISTANT GENERAL COUNSEL, REINSURANCE ASSOCIATION OF AMERICA

Mr. HUNTER. Thank you, Mr. Chairman. A November 3, 1976, *Washington Post* editorial stated, "It is becoming increasingly apparent that liability insurance or the lack of it is becoming a national problem. Rates charged those in professions are rising rapidly. Local governments are finding it increasingly difficult or expensive to buy insurance. Many small companies are dropping insurance."

The editorial concludes, It is a tort crisis. "The legal ingenuity that created the problem is going to have to be used to solve it," the editorial concluded. That editorial was written on November 3, 1976. That crisis was not related to tort law, in my estimation. I appeared before the Senate 10 years ago during the last crisis as Federal Insurance Administrator, and I said it then, and it was generated within the insurance industry. The first chart shows the industry profitability cycle. The last cycle bottom in the mid-1970's resulted in that editorial. Insurers blamed the courts and greedy lawyers for their problems in the mid-seventies, yet at the top of the cycle in the early eighties the insurers fell all over each other to write the once dreaded liability insurance.

In my testimony, I show examples of rate cuts from $105,000 to $5,000 in 1 year for a risk. In 1981 the insurers even wrote insurance on the MGM Grand Hotel several months after the fire that killed many people, as you recall, in late 1980. Insurers quite simply lusted after liability insurance, and not a word was whispered about a tort crisis in the early eighties.

As the charts attached to my testimony show, the 1981 rate cuts cut profits but had the insurers not cut rates they would have maintained their profits at excessive levels. The crisis we now face was caused by insurance rate cuts, period. The insurers have presented no evidence except anecdotes that there is a tort crisis.

In fact, the losses have gone up roughly at inflation. The insurers have abandoned day care centers, claiming a tort crisis, but as Congressman Miller of California found out in his hearings, there were only $5 million in claims in the entire country in the latest year. The MGM Grand Hotel claims last year were 15 times that, $75 million.

Last month the American Insurance Association vice president Grover Chick stated, "Companies are doing what they have to do to get price adequacy. Competitive pressures drove rates down. Generally they are coming back to what they were in 1977 or 1978" adjusted for inflation. Last week Lowell Beck, president of the National Association of Independent Insurers, was quoted as saying that 'The seeds of the current liability crunch were sewn when premiums were set as low as one-

tenth of the previous year's premiums. Simple arithmetic tells you that when premiums are cut to 10 percent of the previous level, a 900 percent increase is needed to bring it back to the proper rate."

When I was Federal insurance administrator, I succeeded in getting two Presidents, Ford and Carter, to support national no-fault auto insurance. I am not against tort reform. The problem is, you do not have the predicate in place. With the no fault we had a 21 volume DOT study. We knew exactly what the cost of claims were with and without lawyers and the like, and also we drafted a balanced bill, quid pro quo, victim compensation.

In no-fault the victim was not just giving up rights. The victim was also getting a better compensation package. The calls for tort reform today are a one-way street. Just take away victims' rights and do not study it first.

States like South Carolina that I have studied very carefully that have hardly any lawsuits are suffering the same kinds of problems that are being suffered in States with significant lawsuits, and from what your opening statement says, it sounds like you are having the same sort of problem in South Dakota.

The Pennsylvania legislature a few years ago cut back the municipal liability by limiting to only eight specific things what you can sue a municipality for, and then only for a total of $500,000 for an event regardless of how damaged you are, and not just pain and suffering. Your total damages are limited to $500,000, yet municipalities in Pennsylvania today are having the same kind of increases that are shown around the rest of the country.

The lack of quality State regulatory oversight has allowed rates to be inadequate before and excessive today. The States have failed miserably to keep the rates right, and thus smoothe the cycle. One measure of this is that State regulation employs 60 of the nation's 7,000 actuaries. Twenty-six States have no actuaries at all on the payroll. Only five States employ those most qualified to handle liability matters, Fellows of the Casualty Actuarial Society.

One key indicated the prices are excessive. The general stock market, the second chart, has risen through the entire cycle, and yet in 1985 during the so-called crisis the Best's property casualty stock index through November 20 is up 44 percent, and this is an indicator that the crisis is over. The profitability is about to go into excessive levels.

Now, what can Congress do? I think it should look at the McCarren-Ferguson Act. I am convinced that you should also be looking at the reinsurance transaction, particularly Lloyd's of London and foreign reinsurers. They had a heavy handed role in the situation. Not only do I think that you should consider regulating them, but more importantly, I think the Federal Government should be given standby authority to enter the reinsurance market at times of great distress.

I administered the Riot Reinsurance Program which was a great success. It made money and kept insurance available in the inner city areas during the riot times. Further, incentives for American investors to enter the reinsurance business should be enacted. Why in the world

should we send billions of dollars to London or Munich to reinsure America? We have the resources here. It should be the other way around if for no other reason than balance of payments, but when London can by whim in effect screw up our economy, we should move to end that situation.

Finally, we should consider amending the Product Liability Risk Retention Act to enable all voluntary groups to form self-insured or jointly purchase insurance like it did for product liability. I think that approach should be extended to other insureds. Anticompetitive State laws which prohibit groups to form for such purposes are protectionist, trying to maximize agents' incomes and they have outlived their uselessness in America's economy.

Finally, you mentioned cross subsidies. There have been cross subsidies. Small businesses have been cross subsidizing and paying too much. They currently are paying too much. There are cross subsidies across State borders that the Federal Government must look at, and I think your hearings are a very important step in that direction, sir.

[The statement follows:]

STATEMENT OF J. ROBERT HUNTER, PRESIDENT, NATIONAL INSURANCE CONSUMER ORGANIZATION

OVERVIEW

We are here today to discuss a mounting crisis among small businesses and across America, a crisis which involves every man, woman and child: the nation is losing its liability insurance. Day care centers are losing their insurance and are being forced to close, perhaps driving second breadwinners out of work or creating new latchkey children. Nurse-midwives are losing their insurance and the lower cost birthing centers are shutting down. Doctors are marching on state capitals because insurance is unavailable or costs have skyrocketed. Cities, transit authorities, even whole states are losing their liability insurance. One of the leading auto insurers in the District of Columbia has pulled out. The list goes on and on.

And prices have skyrocketed. For example, the cost of insuring an automobile in America has gone up at a 9.1 percent rate for the first 6 months of 1985, exceeding the rate of change for all of 1984.[1] The annualized rate of change is 18.2 percent, a record dollar change.

What is going on here? Are these practices of insurers justified?

The answer is *"NO!"* What we are witnessing is a manufactured crisis intended to bloat insurer profits and reduce victims' rights.

Property-Casualty insurance has a cyclical profitability, as Chart Number 1 shows.[2] In 1984, if you accept the insurer's whooping reserve increases as vaild (quite a large leap of faith), they earned about a 3 percent rate of return on net worth (equity). That is too low.[3] It would indicate that their premiums were about 5 percent short. If their premiums had been 5 percent higher, they would have earned a rate of return on net worth of about 13 percent, more than enough for an industry of the low to average riskiness of Property/Casualty insurance.[4]

A five percent premium shortfall is not a crisis. Yet we see all of the cancellations and mammoth price increases such as:

A 70 percent increase for OB/GYNs in Maryland (totally unjustified—per analysis, attached as Exhibit I).

300 percent to 900 percent increases in lawyer and architect malpractice insurance premiums around the country.

Increases of 200 percent to 500 percent for the day care centers who can get insurance. Many can't.

300 percent to 1000 percent increases for public transit authorities.

One Northeastern state's liability insurance was $100,000 for $100 million of coverage last year. This year it's $400,000 for $3 million in coverage. Last year it cost $1.00 per $1,000 of coverage; this year its is $1.00 for $7.50 of cover.

The list goes on and on, but the statistics don't justify any of this!

What is going on?

THE LAST CYCLE BOTTOM—1974/5

If you look again at the first chart you will see that 1984 was a typical "bottom-of-the-cycle" year. The last time it happened was in the mid-1970's when I served as Federal Insurance Administrator in the Ford Administration. At that time, the country observed the precise phenomena we see today. As a *Washington Post* editorial of November 3, 1976 put it:

It is becoming increasingly apparent that liability insurance—or the lack of it—is becoming a national problem. . . . The rates charged those in professions other than medicine, most notably architects, are rising rapidly. Local governments are finding that it is increasingly difficult or expensive to buy insurance covering their police departments. And because of the price now placed on it, many small companies are dropping the product liability insurance they thought they needed. . . .

It is no doubt true that the increasing number and size of judgments against police departments for false arrest or mistreatment of prisoners have had some salutory effects on police behavior. Similarly, malpractice suits have provided an incentive for more careful medical care, and product liability suits have forced manufacturers to produce better and safer products. But there must be some limit to all this, and we suspect it has been passed. The real beneficiaries of this litigation explosion have been the lawyers. . . . There has to be a better way of compensating those to whom reparations are due than the clumsy and expensive mechanisms that exist today. The legal ingenuity that created the present problem is going to have to be

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Footnotes at end of article.

used to solve it. Otherwise, the whole system of liability insurance and of personal liability for wrongdoing is going to collapse of its own weight.

After insurers abandoned the medical and product manufacturer lines, the federal government reviewed the situation. I was fortunate to be part of the interagency working groups that found that there were no justifications for the insurer actions.[5] We concluded that the insurers had just panicked from lack of data.

But look at what happened; their profits skyrocketed to all time record levels. Insurers learned that the state regulators would, during the panic, give away the store in rate increases. Insurers also learned that state legislators would act to reduce victims rights in the wake of the panic (over half the states do so [6]). The fact that insurers achieved much of their 1975 legislative agenda and now are back for a bigger bite from the apple is very significant. Now, medical professionals want caps on overall and non-economic damages and municipal governments (and especially insurers!) are seeking elimination of joint and severable liability and punitive damage awards. Where will this raid on victims rights end?

They are applying the lessons they learned in the mid-1970's very well today—to day care centers, to nurse-midwives, to doctors, to product manufacturers, and so on. They are petitioning Congress for product liability and medical malpractice tort law changes and the states for changes in other tort systems.

THE HEAT IS ON

Some property/casualty officials have made statements on the public record that; "It is right for the industry to withdraw and let the pressures for reform build in the courts and in the state legislatures." [7] Reinsurance, a critical aspect of maintaining available and affordable insurance rates may not be available from overseas because syndicates would "simply not write reinsurance for the American casualty industry" in 1986. A representative of that overseas market (Lloyd's of London) was recently reported to have said that if a new policy form is not adopted by state regulators, reinsurance wouldn't be provided to American liability underwriters. When I recently testified before the Maryland Governor's Special Medical Malpractice Committee, a medical malpractice insurance company executive told the committee that higher rates for ob/gyns in Maryland were put into their filing because the reinsurer required it, not because the rates were actuarily justifiable (which they weren't).

Wall Street knows what is going on. Chart Number 2 shows that the property/casualty stocks have soared to record highs more than doubling the Dow Jones Industrial Average rise for 1985. Through November 20, 1985, the Best's Property/Casualty Stock Index was up by 44 percent compared with a 20 percent Dow Jones increase.[8] Wall Street expects state regulators to allow excessive rate increases; Wall Street is right! At the end of the first six months of 1985, the surplus of insurers has skyrocketed by $8 billion, over the year earlier figure, a growth of 13.4%.[9]

Insurers blame this crisis on the courts and the tort law and say the only way to fix it is to take away as many victims' rights as possible. They can point to such statistics as these.

"Of 28 insurers writing liability insurance for day care centers in Maryland last year, 15 have left the market. Of the remaining 13, six will not write any new business. The last 7, those who will write new business, *all* have excluded child abuse from their policies. The Maryland Commissioner of Insurance has termed the pull out "hysteria" since no data supports it." [10]

Insurers will say this points to the need for tort reform,[11] while admitting that data don't justify the pull out.[12] In New Jersey, at a hearing where ISO requested the new claims made form, the ISO could not say how many million dollar CGL type claims there were in recent years, nor what percentage of claims paid were in suit last year. Iowa Insurance Commissioner and NAIC president, Bruce Foudree says that "regulators cannot trust annual statements and quarterly financial data. We [regulators] will therefore need to get tougher and spend more time looking over companies' shoulders. We cannot tolerate falsification or deception on annual statements."[13]

I do not believe that there is a tort crisis across the nation, I believe we are witnessing joint action by insurers intended to create an atmosphere where rates can be put too high and legislator will be intimidated into action designed to take away victims' rights and to allow wrongdoers to go unpunished. It was no accident that A.H. Robbins tried to piggyback onto federal tort "reform" to be excused from its misdeeds.

At the top of the cycle a few years ago, the now-dreaded liability insurance policy rates were being slashed wildly and even being sold after the insured event happened, such as in the case of the MGM Grand Hotel fire where liability coverage

was written months after the fire.[14] Chart #3, labeled the "National Insurance Strike," shows the effect of rate cutting during 1981 and 1982 upon the profit levels of insurers. As you can see, the insurers cut about $1.5 billion in premiums over this interval and the resulting impact upon insurers profits was vastly significant—they plummeted. Chart #4 shows the profit levels insurers would have enjoyed had insurers *not* cut their premiums, but only maintained them at 1981 levels. Chart #4 shows great disparity between actual profits and those able to have been realized had insurers simply held the line on premiums. Obviously, if premiums were increased at the same level as, say, the Consumer Price Index, insurer profits could have been higher than the levels indicated in Chart #4. The national problem of insurer profits is clearly and convincing self-inflicted.

If tort reform was so desperately needed in 1974 and 1975, why not in 1981? Why again today? The crisis is within the insurance industry, not in the courts.

When insurance trade association representatives talk to legislators, they point their fingers at the tort system for all their financial ills. But, amongst themselves, insurance association representatives and insurance company executives are more honest and admit their culpability for the current capacity crunch. A recent report put out by the Insurance Services Office (ISO) and the National Association of Independent Insurers (NAII) concluded that:

"The property/casualty industry must accept the major responsibility for its current financial condition. But, the brutal price war of the last six years is over. The industry has finally realized that a business cannot indefinitely price its product below cost and expect to survive."[15]

Now, we are asked to take the insurance industry's word that there is a tort problem and that limits on pain and suffering or on overall damages must be imposed so that rates will go down. All the evidence so far indicates that such caps have no effect on rates whatsoever.

Virginia has had limits on medical malpractice damage for years, but I was still called to testify before the legislature this year about insurance problems. Pennsylvania enacted one of the most restrictive immunity acts on record for its political subdivisions in 1978.[16] Yet, despite those limits, Pennsylvania has another "crisis" in municipal liability insurance. A recent national study of the impact of "reforms" after the last crisis showed that caps on pain and suffering in medical malpractice cases have had no statistically measurable impact upon premium increases.[17]

I have done a lot of work in North and South Carolina as a consultant to the state governments. I am convinced that the degree of litigeousness in the Carolinas is low, significantly below that of other states where I work, for example. Such actuarial calculations as the loss development and the ratio paid to incurred losses, which I use for investment income purposes, make it crystal clear that, if there is a tort problem in this nation, it has not manifested itself in these states.

Yet, South Carolina has had to issue emergency regulations requiring no mid-term cancellations and 30-day notice of non-renewal price increases. If the crisis were truly tort based, South Carolina would *not* have to undertake such action. The fact that South Carolina insureds are feeling the same "hit" as the other states is strong evidence that the law is not causing the crisis, but rather that it is a creation of insurers.

In plain English, what the insurers propose in so-called "tort reform" hasn't worked and won't work. The evidence points overwhelmingly to a substantial insurance problem, both in the regulation and management of the property/casualty industry.

Insurance premiums represent 11.1 percent of the disposable income in this country.[18] Insurance is the fourth leading purchase Americans make (behind food, housing and federal income taxes, although we expect it to pass federal taxes this year). Insurance rates have grown at an 18 percent rate for the first six months of 1985. If we are to see any relief, specific steps will have to be taken at both the state and federal level to end this insurance company misbehavior.

THE MC CARRAN-FERGUSON ACT

In 1944, the Supreme Court of the United States found that insurance was interstate commerce and, thus, subject to anti-trust and other federal statutes. In 1945, under heavy insurer pressure, Congress passed the McCarran-Ferguson Act which uniquely exempts insurance from the federal anti-trust laws (except should intimidation, coercion or boycott occur). Congress delegated the authority to regulate insurance to the states with no standards for regulatory excellence and no ongoing congressional oversight. Indeed, the Federal Trade Commission (FTC) cannot even study insurance under current law[19] unless Congress specifically authorizes it in ad-

vance. (FTC's power was revoked because they had the audacity to point out that whole life insurance was not a wise purchase for most Americans. The fact that the FTC was right did not alter their fate.)

The immensely important McCarran-Furguson Act was adopted by that earlier Congress without benefit of a hearing. The legislative history makes it clear that President Roosevelt wanted only a short, two- or three-year moritorium after which anti-trust laws should fully apply.[20] That is, in fact, what both houses of Congress adopted but their language was somewhat different, requiring a conference. Mysteriously, the conference committee reported back a bill that continues in effect today; an infinite moritorium.

Every independent study of insurance concludes that the states have failed miserably in their attempts to regulate this giant industry.[21] The states have allowed this crisis to happen. Had regulators had the potential political will and been properly equipped to keep prices to statutory standards (all states require that the rates be "not excessive, not inadequate, not unfairly discriminatory") we would not be in the mess we are in today with clearly excessive prices going into effect routinely around the nation and unfair mid-term cancellations, coverage and price changes rampant.

WHAT SHOULD CONGRESS DO?

(1) NICO has called upon the Judiciary Committee of the U.S. Senate and House to review the McCarran-Ferguson Act to determine if it is working to protect America. The quality of state regulation is documented to be inadequate; the insolvency funds are a "Maryland S&L Crisis Waiting to Happen." I do not call for the elimination of state regulation here as some insurers recently have. I believe that federal standards for state regulation, coupled with federal oversight on a continuing basis, are needed. Further, the federal government should take over the insolvency funds, making them an FDIC-type operation.

(2) NICO also believes that the approach enacted at a previous bottom, 1968/9 is worthy of consideration by Congress: The Urban Property Protection and Reinsurance Act of 1968 was a response to the unavailability of insurance in the inner cities in the wake of the riot situation of the late 60's.[22]

To be sure, the predicate for the withdrawal of riot insurance was strong, given the very serious situation extant in the country at the time. But the finding of the President's Panel on the Insurance Crisis is just as valid for the day care provider community today and others losing coverage as it was for the inner city communities of the late 60's when the panel found that; "Communities without insurance are communities without hope." [23]

In the riot insurance crisis, the federal government agreed to reinsure (insure the insurance transactions of the insurance companies—a sort of lay-off bookie arrangement) the insurers against the specified peril of riot and civil commotion in return for a reinsurance premium and a commitment to participate in a pool to make sure insurance is available to all residents whose homes met reasonable standards of insurability.

The federal government made $125 million writing this reinsurance!

The cities were saved from the sure death that being uninsured brings in twentieth century America!

I think that a program of stand-by authority should be prepared to take care of the day care and nurse-midwives current problem (and, perhaps, some of the others). The authority should be granted to cover future crises as well, to stabilize the insurance profit cycle's harsh symptoms. I have provided a copy of a draft bill to establish such a program to your staff.

Insurers, the administrator of the program and representatives of the distressed industry would meet to set standards for insurability under which those who qualify are assured of an insurance market.

Studies will be undertaken to determine if other longer range actions (risk management, insurance reform, etc.) are also needed to resolve underlying problems.

Funding for this program would come from reinsurance premiums. I also envision a small surcharge, perhaps one-quarter of one percent of premiums written by all property/casualty insurers, to back up the program. This is in case premiums are insufficient over a short period or if it is determined by Congress that some short term subsidy is required to stabilize a distressed line sometime in the future.

(3) NICO has asked the Department of Justice to review the evidence to see if a conspiracy to boycott insureds has occurred in day care insurance and other lines, the intent of which is to intimidate state regulation into granting excessive rate increases and to intimidate state and federal legislators into passing unjustified tort law modifications which will maximize insurer profit levels.[24] Such boycotts and in-

timidations are *not* exempt from federal review under the provisions of the McCarran-Ferguson Act. NICO has called upon the Congress to monitor activity upon this important request, which has prompted a preliminary investigation by the FTC.

(4) NICO has called upon the Congress to require federal licensing of alien insurers that are not licensed and meaningfully regulated by any state in this nation but who insure or reinsure here. If Lloyd's of London will use its economic clout to dictate our nation's policy forms, (it is Lloyd's which is pushing the claims made form down the throats of the primary carriers; it is Lloyd's which is forcing the defense costs inside the limit of liability) we think they should be subject to review by some authority here.

(5) NICO proposes that the Congress modify the Product Liability Risk Retention Act of 1981[25] to allow small businesses as defined by the Small Business Administration at 13 CFR 121 to form risk retention groups along the lines already authorized under the statute. Targeted assistance through the proposed reinsurance program can assist those small business insureds who are too few to form risk retention groups in a given state.

WHAT SHOULD STATES DO?

States must concentrate their major efforts on insurance reform and not tort "reforms."

(1) States should encourage the federal government to seek a more pro-active role in the regulation of the insurance business. It is a sign of strength, not weakness, to ask for help when it is truly needed, and states surely need help in this area today.

(2) The US General Accounting Office noted that the most critical deficiency in the regulation of insurance by the states was in the shortage of proper staff for adequate regulation.[26] The GAO pointed out that this was a function of money and increased resources for targeted staff development for actuaries, accountants and lawyers will improve the quality and extent of state regulation of the insurance business. Regulators need to develop staff in the critical areas outlined and must be given sufficient resources to do so.

(3) State law must require disclosure of loss data on a line-by-line basis which would give regulators much better ability to discern whether rates are excessive, inadequate or unfairly discriminatory. Line-by-line reporting will allow for adjustments between personal and commercial lines. Companies' annual statements should be expanded to require detailed reporting of all general liability subline data, by subline.

(4) To the maximum feasible extent, insurance rates must be made based upon experience. The failures of the regulators and the insurers to provide proper safety incentives lies chiefly in their unwillingness to rate commercial risks based upon individual experience. Admittedly some risks are hard to rate experentially, but over time the necessary data base can be developed to properly rate individuals and unusual risks. Experience rating will allow proper market messages to be sent to unsafe risks and reduce the costs for good risks currently paying to allow the continued operations of bad risks. Nowhere is this more critically needed than in medical malpractice rates.

(5) Tough conflict-of-interest statutes must be enacted in the states to prevent continuation of the "revolving door" found by the USGAO where 50 percent of regulators came from the industry and 50 percent went to it after being a regulator.[27] An "arms length" relationship between regulators and the regulated industry must be established.

(6) Insurance regulators need better data verification techniques either through conducting their own, more frequent audits or using outside auditors. Recent charges by the NAIC president that data has been falsified strikes at the core of state regulation of insurance. If we cannot trust the annual statements, then state regulation of insurance is a fraud and a sham.

(7) Insurers must be required to fully disclose to regulators the total rates of return earned, including on investment income, so that full blown rate of return rate regulation can be utilized. The NAIC endorsed this approach at its June 1984 meeting. Texas, the first state to fully use the method in setting auto rates earlier this year, saw a 10 percent reduction in premiums required. This action saved Texas consumers $250 million over the proposed rates.

(8) State Commissioners must be empowered by the legislatures to meaningfully regulate excess, surplus lines carriers and reinsurers, at least to the extent that the federal government does not. Abuses, such as withholding cover by these carriers, have contributed significantly to the current capacity crunch.

(9) States need to establish their own reinsurance programs modeled after NICO's federal proposal. A state reinsurance program with a risk management component requirement can bring meaningful safety considerations into insurance markets. Establishing models for risk management as a requirement for reinsurance through the state would provide a general market incentive and would ease availability and decrease risks faced by consumers and their primary carriers.

(10) States need to examine their anti-group and anti-rebate statutes to see if they serve any public purpose. If these laws adversely impact upon availability and affordability of cover, then they should be scrapped.

(11) State regulators should conduct financial, market conduct and trade practice examinations on a regular basis for all licensed insurers in states. Increased monitoring of insurer's practices and finances can only benefit consumers by curbing rating and other market abuses, as well as insolvencies.

(12) Regulators must resist attempts by industry advocates to force proposed claims made forms, which include defense costs inside the limit of liability, upon consumers.

The proposed, and constantly modified, ISO claims made form means less coverage, more exclusions and less competition for insureds.

There is less coverage because of the timing of coverage involved in the policy and the proposed inclusion of defense costs inside the limit makes coverage illusory. If a buyer has a million dollar claim against it and a million dollars are spent by the insurer defending the suit from which the loss accrued, there is nothing to pay for the loss but the assets of the insured. That's not coverage, its an insurance defense lawyer income security plan! The proposed pollution exclusion is simply a refusal to write this risk until the tort law is changed to suit the industry. It is fascinating to note that ISO does not discount the claims made policy rate a whit for excluding "high cost" pollution coverage. ISO cannot have it both ways; either pollution cover costs a lot and the exclusion should cause a dramatic drop in price, or it costs little (nothing according to ISO) and the coverage should be contained within the policy. Consumers face captivity because of the exhorbitant levels of premium for extended tail coverage that can go as high as 200 percent of the last year's premium. The higher the tail coverage cost, the less likely you are to seek more competitive rates at another company.

Claims made poses a particular problem for the unsophisticated purchaser. Believing that they are getting the same coverage for less, many insureds will immediately purchase the new policy and suffer unanticipated losses. I think that if states adopt any form of the new claims made policy form that it should not be allowed to be sold to small business consumers at all. ISO admits that its "problems" are with only five percent of its larger accounts. It would be inappropriate for regulators to broadly restrict cover based upon scarce, potentially false, and small samples of data. In the alternative, if it can be shown that some small business consumers (again, as defined in 13 CFR 121) would be able to benefit from the new policy form, then that form should be made available to such consumers but only after a reasonable occurrence policy quote is given and a full and complete disclosure of the differences of cover is made by the seller. Disclosure forms could be promulgated by the regulators with input from consumers and the industry.

In any event, states should not approve this moving target, constantly amended form until the industry has had time enough to educate the agents and the consumer. Even if the latest amendments are the last, which I doubt, the form should not become effective before July 1, 1986 at the earliest.

(13) States must allow greater consumer representation before the regulatory bodies. All too often the only parties to rate cases are the regulators and the insurer. States must give greater funding to or create Offices of Public Advocate to statutorily intervene in insurance rate cases. The New Jersey experience can serve as a good model, there the costs of intervention are billed back to the filing party and this causes minimal growth in appropriations expenditures while maximizing consumer protection from abusive insurance rates. A related program could be authorized by the federal government or the states to allow consumers to organize their own Citizen's Insurance Board to intervene on their own behalf as a complement to the efforts of the Public Advocates.

CONCLUSION

America deserves a better deal on its insurance. The federal and state governments cannot sit idly by and let the insurance industry hold day care providers, nurse-midwives, and others, hostage in a large game beyond the providers' control. The terrorist tactics of insurers every 10 years at cycle bottom must be dealt with in

a systematic way that adds the stability to our economy that insurance is meant to deliver. Periodic price gouging must be stopped. It is time for the states, as well as the federal government, to act responsibly in the area of insurance regulation and take appropriate remedial action now.

FOOTNOTES

[1] CPI data on "auto insurance", Bureau of Labor Statistics.

[2] Source of data: Citibank Economics and Insurance Services Office.

[3] The ISO admits that the p/c industry had a positive return on net worth last year, conceding the point that the industry did not lose money last year. But, ISO's Mavis Walters disputes the level of that return, saying it was only two percent on net worth. Even at that level, the premium shortfall for last year was only 5.5 percent or so. (*See*, Statement of Mavis Walter, Senior Vice President, Insurance Services Office, Inc., before the House Energy and Commerce Subcommittee on Commerce, Transportation and Tourism hearings on the Liability Insurance Crisis of 1985, p. 16 (Sept. 19, 1985)).

[4] For a discussion on risk in the property/casualty insurance business, see *Investment Income and Profitability in Property/Casualty Insurance Ratemaking*, J.R. Hunter and J.W. Wilson, 1983, Chapter 5.

[5] Hearing on December 3, 1985, Subcommittee on Health of the Committee on Labor and Public Welfare, US Senate. Among the interesting data supplied by ISO at that hearing were exhibits that showed that the average claim cost ISO used for ratemaking significantly exceeded the limit of liability, clearly ratemaking that had run amok. That led to this exchange:

Sen. LAXALT. Is malpractice always a loser as far as carriers are concerned?

Mr. HUNTER. If they charge these rates, they could not help but win. (Page 141.)

In John Guinther's book, *The Malpractitioners* (Anchor Press, 1978), Guinther cites this exchange at page 169 in a chapter entitled "They Won," Guinther reviewed the later experience.

Final Report, Product Liability Task Force. *Report on Product Liability Ratemaking*, Product Liability and Accident Compensation Task Force, US Department of Commerce, 1980. At page ix the *Report* states that "overly subjective ratemaking practices were one of the principal causes of the product liability insurance problem."

[6] *St. Louis Post Dispatch*, Section B, p. 3, 4/14/84. (*See also*, Sloan, *infra*, at note 17).

[7] *Journal of Commerce*, "Insurers Told: Exist Some Lines," p. 8A (June 18, 1985).

[8] Source of data: *Best's Property/Casualty Stock Index*, A.M. Best and Company, Oldwick, NJ. December 31, 1984 index=416.30; November 20, 1985 index=600.06. Dow Jones Industry Average December 31, 1984=1211.57; November 20, 1985=1441.37.

[9] According to the Insurance Information Institute's *Executive Letter* of August 26, 1985, Policyholder surplus grew from $58.2 billion as of 6/30/84 to $66.0 billion as of 6/30/85.

[10] "The day care facilities have been caught up in this availability crunch and are being deemed higher risk, not necessarily based on a claims experience but due to an insurance hysteria . . ." Testimony of Edward J. Muhl, Insurance Commissioner of the State of Maryland, before the House Select Committee on Children, Youth and Families, July 30, 1985.

[11] "Any permanent solution (of the day care insurance crisis) will require significant changes in the tort system." Testimony of Frank Neuhauser, Vice-President and Actuary for AIG (a leading insurer of day care centers) before the House Select Committee on Children, Youth and Families, July 30, 1985.

[12] "The countrywide experience for those companies reporting premium and loss data to the Insurance Services Office . . . appear to conform with the current loss experience for the majority of commercial insurance lines . . . (these data) do not suggest that insurers should abandon the market." Testimony of James L. Kimble, Senior Counsel, American Insurance Association, before the House Select Committee on Children, Youth and Families, July 30, 1985. The testimony was also endorsed by the Alliance of American Insurers.

[13] *Journal of Commerce*, "Tougher Insurance Rules Loom," p. 1A (Oct. 10, 1985).

[14] See, for instance, the *National Underwriter*, 11/20/81, page 1, where it says:

"A large commercial umbrella (liability) risk came up for renewal and was rated at $105,000, about the same as the previous year. But the insured was not satisfied. Aware of the aggressive rate competition in the commercial lines market today, he decided to shop around. He approached a second agent, who submitted the very same risk to a different company, which offered to write it for just $20,000.

"But the insured was still not happy. He continued shopping and eventually *the original company, which originally wanted $105,000 came back and took the business for $5,000. That's right, $5,000.*" (Emphasis added.)

[15] NAII and ISO, "1985: A Critical Year," p. 30 (Spring 1985). This quote has been curiously lacking in any reference made to this document by insurers in previous testimonies. (*See*, Walters, *supra*.)

[16] Pennsylvania Political Subdivision Tort Claims Act, (42 Pa. CSA 8541 et. seq.)

[17] Sloan, Frank A., "State Responses to the Malpractice Insurance "Crisis' of the 1970s: An Empirical Analysis," 9 *Journal of Health Politics, Policy and Law*, 629 (Winter 1985).

[18] See table below.

Item	1984 amount spent in billions [a]	Column (1)—1984 disposable income of $2,578.1 billion [a] (percent)
Food	444.3	17.2
Housing	397.8	15.4
Personal income taxes	302.6	11.7
Insurance [b]	287.1	11.1

[a] Source: U.S. Department of Commerce, Bureau of Economic Analysis.
[b] Source: *"Bests Management Reports", December 31, 1984, page 1. "Life Insurance Fact Book", page 56. Blue Cross Association, Telephone call of 1/25/85.*

[19] The law was euphemistically entitled the "FTC Improvements Act of 1979."

[20] See Statement of the Honorable Claude Pepper before the Subcommittee on Monopolies and Commercial Law on the Insurance Industry's Antitrust Exemption, April 11, 1984; found at page 5 of the Subcommittee's report, *Competition in the Insurance Industry* (Serial No. 127).

[21] See, for instance, *Issues and Needed Improvements in State Regulation of the Insurance Business*, General Accounting Office (Oct. 9, 1979) (hereinafter, GAO Issues); *The Invisible Bankers*, Andrew Tobias (Linden Press, 1982); *The Life Insurance Game*, Ronald Kessler (Holt, Rinehart and Winston, 1985); "Protection for Sale: The Insurance Industry," NBC-TV News (1981); *Risk, Reality and Reason*, the Conference of Insurance Legislator (September 1983).

One of the tests of state preparedness to deal with a crisis in availability and pricing of liability insurance is actuarial staff. Of the 52 states (including DC and Puerto Rico) NICO surveyed, we find that 26 have actuaries. So one-half of the states have no actuaries at all. There are 62 actuaries employed by the States, of the 7,682 actuaries in the nation. It is well known in the industry that those best suited to deal with matters pertaining to liability insurance are those who have passed the examinations enable them to be "Fellows" in the Casualty Actuarial Society. State regulation has only 8 such persons. They are employed by only 5 states [Connecticut (1), Massachusetts (1), Michigan (1), New Jersey (1) and New York (4).]

Aetna Life and Casualty Insurance Company alone employs 126 actuaries. Travelers has 100.

Source of Data: American Academy of Actuaries 1985 Yearbook and Directory of Members by Business Affiliation.

[22] Public Law 90-448, 82 Stat. 476; 12 U.S.C. 1749bbb, 42 U.S.C. 4011.

[23] *Meeting the Insurance Crisis of Our Cities*, A report of the President's National Advisory Panel on Insurance in Riot Affected Areas, January, 1968, p. 1.

[24] See Exhibit II for a copy of the letter to the Justice Department.

[25] 15 USC 3901 et. seq. and 1983 amendments.

[26] *GAO Issues*, p. 35.

[27] *Ibid.*, p. 176

CHART NO. 1

THE "CYCLE" AND CONSUMER ABUSE

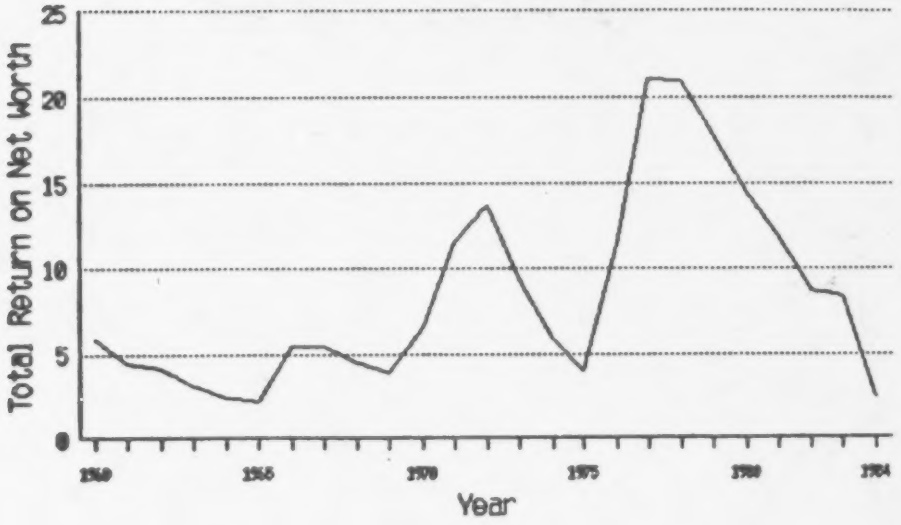


CHART NO. 2

Best's Property/Casualty Stock Index

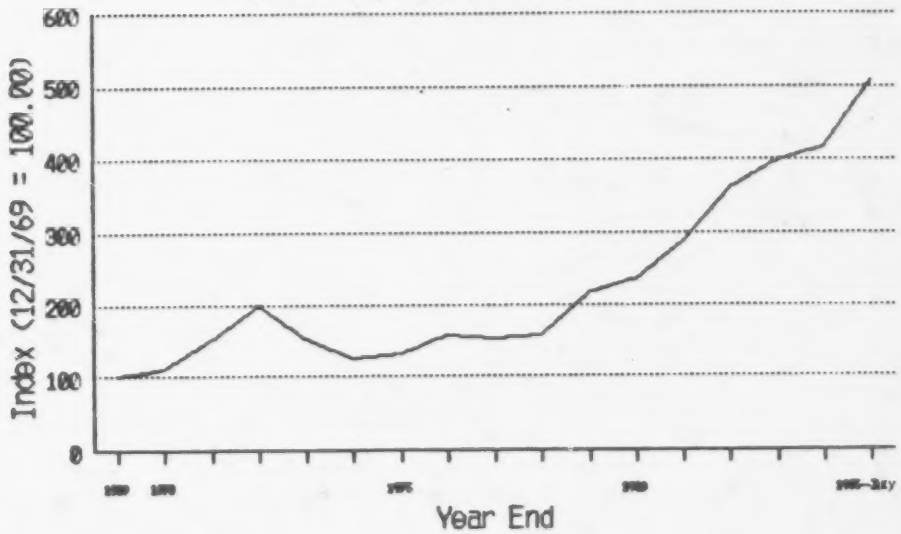
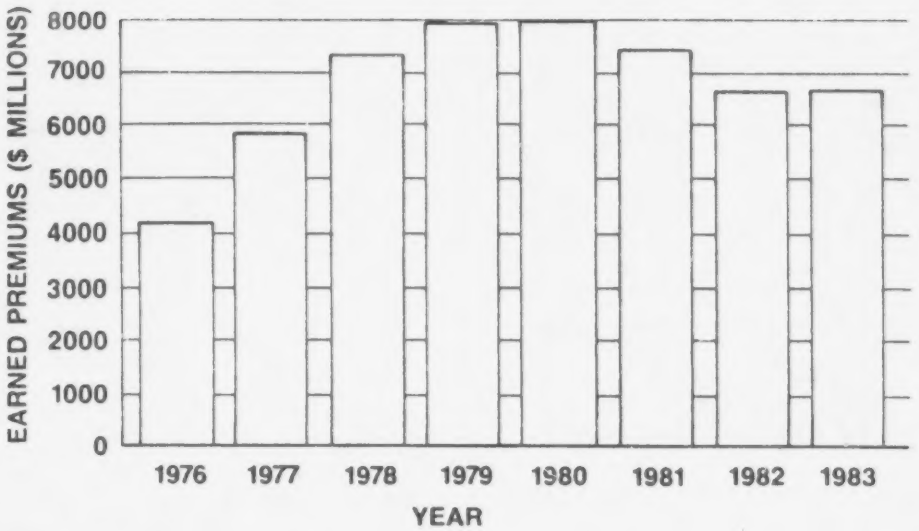


CHART NO. 3

NATIONAL LIABILITY INSURANCE STRIKE



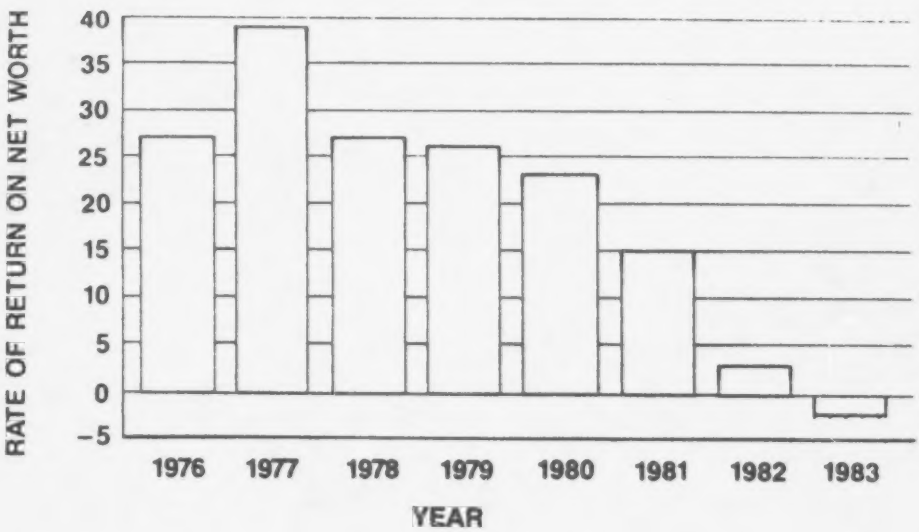
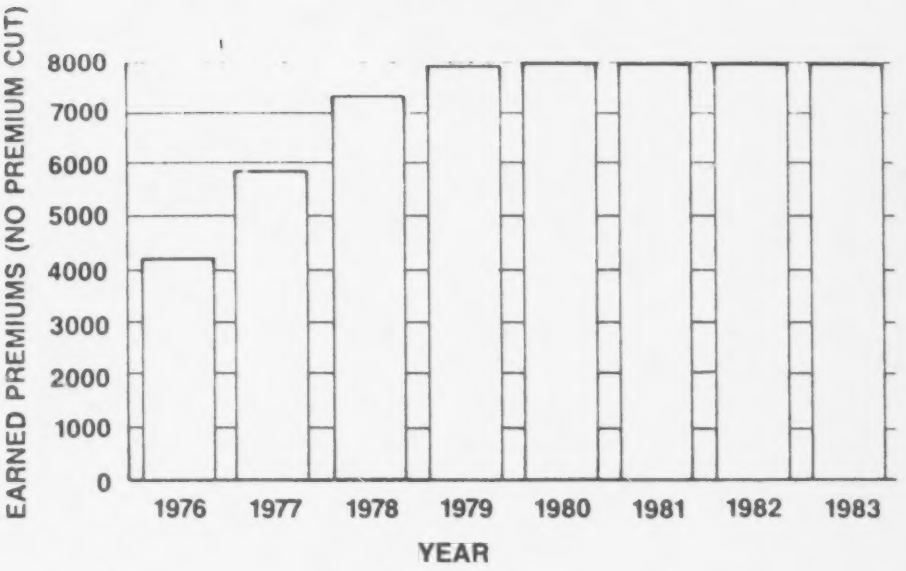
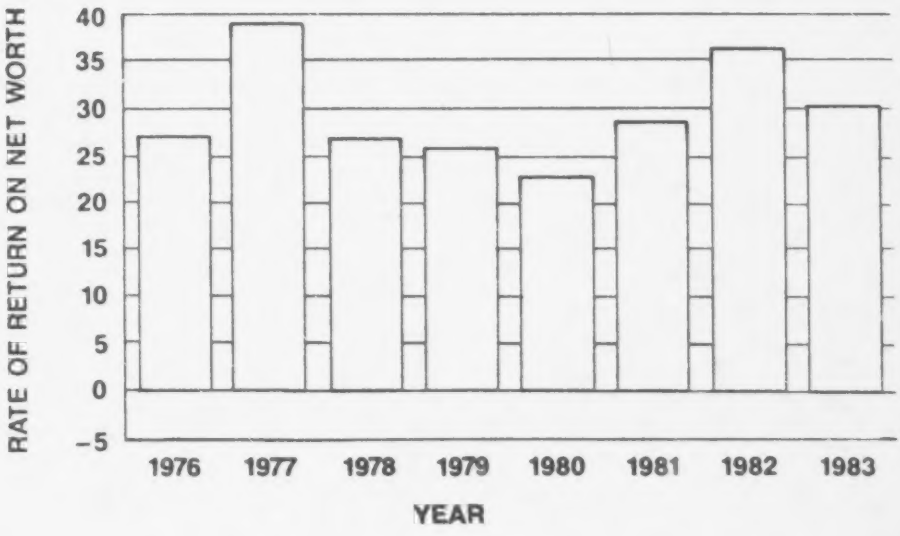


CHART NO.4

NATIONAL LIABILITY INSURANCE STRIKE II





COMMERCIAL LIABILITY INSURANCE PROFITABILITY STATISTICS [1]

Rate of return on net worth [2]

Year	Earned premiums (millions of dollars)	Actual ROR (percent)	All American industry [3] (percent)
1976	$4,160	27	13.3
1977	5,865	39	13.5
1978	7,334	27	14.3
1979	7,943	26	15.9
1980	7,969	23	14.4
1981	7,416	15	14.0
1982	6,627	3	11.0
1983	6,671	−2	11.2
Average		19	13.5

[1] Source: National Association of Insurance Commissioners Report on Profitability By Line, By State.
[2] Rate of Return on net worth estimated from the NAIC Reported Insurance Operating Profit on Earned Premiums by converting to net worth by multiplying by a 2:1 Premium/Net Worth Ratio. Investment Income on Surplus is added at an assumed after tax yield as follows: 1976, 5.0%; 1977, 5.5%; 1978, 6.0%; 1979, 6.5%; 1980, 7.0%; 1981, 7.5%; 1982, 8.0%; 1983, 8.5%.
[3] Fortune 500, 1976–1980; Business Week, 1981–1983.

NOTE: Had the insurers *not* cut premiums after 1980 but held them constant, the Rate of Return on New Worth would have been: 1981, 27 percent; 1982, 37 percent; 1983, 31 percent; and 8-year average, 30 percent.

The problem is clearly rate cutting, nothing else.

Data underlying charts 3 and 4.

[The following information was subsequently received for the record:]

QUESTIONS OF SENATOR PRESSLER AND THE ANSWERS

Question. Could you briefly explain how you arrived at the conclusion that an additional 5 percent premium increase in 1984 would have resulted in a 13 percent return for the insurance industry?

Answer. According to the insurers, they earned a return on net worth of 2% in 1984. They needed to collect in the 12–13% range, slightly below the all-industry return. (This is because insurers are slightly less risky than the average industry—See Wilson/Hunter study, *Investment Income and Profitability in Property/Casulty Insurance Ratemaking*, January, 1983). Thus they needed 10–11% more return on net worth. Since they write $2 of premium for each $1 of net worth, this means they needed to earn 5 to 5½% more on premium. Had they collected 5% more premium, plus the investment income that would yield, they would have had an acceptable profit.

Question. Do you feel that establishing a Federal reinsurance program would transfer the "deep pocket" from local governments, business, or insurance companies to the Federal Government?

Answer. No. It is highly doubtful that who reinsures is ever known in court.

Question. Do you feel that Federal action is appropriate in an area where insurers are refusing to write insurance, such as pollution liability?

Answer. Yes. EPA requires pollution coverage and, thus, must be able to assure those upon whom it imposes the requirement that *reasonable* risks can get insurance.

Question. What is the status of the Federal Trade Commission's investigation into any conspiracy on the part or insurers to boycott certain lines of insurance?

Answer. You must ask the FTC this question.

Question. How does the insurance industry determine rates? Are rates set on a State-by-State or nationwide basis? What is the relationship between claims incurred and premiums charged.

Answer. It varies by line of insurance and by state and by time. Some lines are set nationwide (e.g., Products) others by state (e.g., Auto). Some states require prior approval, some don't even require filing. Sometimes insurers ignore their actuaries' view of the data on the low side (e.g., cash flow underwriting) sometimes on the high side (e.g., today's excessive prices).

Question. My towns in South Dakota complain that, despite what are generally very good claims records, their premiums continue to skyrocket, and in many cases

they cannot find insurance at any cost. How does the claims record of a municipality affect the premiums paid for coverage?

Answer. Now claims data are often irrelevant because insurers are charging what the market will bear, without regard for the excellence of the municipalities' experience or risk management. During the cash flow underwriting days of the early 80's, it did not matter how bad your experience was, you got insurance for a song. This boom/bust approach to insurance is highly damaging to our economy generally and to our cities specifically.

Question. How does the agreement between a primary insurer and a reinsurer affect the coverage and premiums offered by the primary insurer?

Answer. I attach material on how reinsurers are currently bullying primary carriers into high rates and coverage charges. I suggest that unregulated foreign entities, such as Lloyds of London, have tremendous influence on our economy (even Parliment does not regulate Lloyds, states don't either—the federal government should).

Question. The current problems in the insurance industry have been attributed to poor underwriting practices, shortcomings of the civil justice system, and the cyclical nature of the industry. Could you please rate, on a 100 point scale, the relative importance of those three factors, or any additional factors, as cause of the current "crisis?"

Answer.

	Percent
Poor underwriting	40
Civil justice	10
Cycle	50

Question. What actions can or should governments take to correct the insurance cirsis, and should the action come from the State or Federeal Government?

Answer. Both Federal and State action is needed, as I testified. I have become alarmed at the pervasive influence of foreign reinsurers and the need for federal action in this area.

Question. What percentage of the insurance industry's annual expenses is defense costs?

Answer. It depends on the line of insurance, varying from as little as a few percent up to about ⅓ of experience. Insurers should give you a detailed response to this question.

Question. Have insurance premiums decreased in any States that have capped certain types of civil damage awards?

Answer. No.

Question. The insurance industry often cites the *Jackson Township* case as evidence that judicial actions are making insurance underwriting impossible. Is this the trend all across the country? Are there other cases where a complaint brought on grounds similar to those in *Jackson Township* was dismissed or decided in favor of the insurer?

Answer. It is not a national trend, as I understand it. But a lawyer should answer this question based on a review of decisions in the various courts.

In 1984, our industry experienced its worst year ever. Underwriting losses since 1979 reached $55 billion, $21.3 billion in 1984 alone. The combined ratio, which is a technical term, but it is a measure of the industry's success or failure at its basic business, that is, writing insurance, it reached 118 in 1984 for all lines of business combined. That means very simply that it took $118 to cover losses and expenses for each $100 of premium earned.

Now, although underwriting results have gotten steadily worse since 1979, investment income has grown continuously. I would refer you to chart 1 now, and it is also attached to my formal statement. The dotted line shows you the underwriting—excuse me, the solid line towards the bottom of the chart refers to the underwriting.

Senator PRESSLER. That is the red line.

Ms. WALTERS. Yes, it is a solid line on my chart here, but it is a red line on the big chart. You can see how that has gone steadily downward. But investment income, the dotted line or, I guess, blue line on your chart, the same one on chart 1, has increased and grown continuously.

The problem, however, is that the average annual investment income growth of $1.7 billion did not even come close to the average growth in underwriting losses of $3 billion in 1984. Although investment income grew by 10 percent, underwriting losses grew by over 60 percent. And that produced a pre-tax operating loss of $3.8 billion. That is the second chart.

The second chart, gentlemen, is simply a combination of the figures on chart 1 and chart 2. That is the combination of underwriting losses and investment income. That is the bulk of insurers' operations, pre-tax operating income, and you can see it was a loss of $3.8 billion. Clearly losses of that magnitude cannot be sustained without serious adverse consequences.

On a total income basis, that is, if we include other items besides the two major ones, other items such as realized capital gains tax credits and miscellaneous income items, add all of those in so that on a net income basis there were profits in the insurance business in 1984, but at a distressed level.

Senator PRESSLER. The red line is the profit?

Ms. WALTERS. We should be now on chart 3, and that shows the industrywide rate of return on net worth compared to the Fortune 500. The insurance industrywide rate of return in 1984 was only 1.7 percent, which was more than 11 percentage points below that of the Fortune 500. In fact, in the property casualty industry 50 of the top 100 insurer groups in the United States actually had a negative return on net worth in 1984.

Another point I would like to emphasize is that the current property casualty underwriting cycle is dramatically different from any cycle this industry has experienced in the past, and because it is not typical, unusual, and severe problems are emerging, and the solutions to those problems are not easy or readily apparent to any of us.

Unfortunately, the 1985 results so far continue the past pattern as opposed to what Mr. Hunter just said. Operating results for the first 9 months of 1984 continue in the red at a very disarming, discouraging level. For the first 9 months of 1985, pre-tax operating losses have reached $3.5 billion. That compares with a $2.5 billion pre-tax operating loss this time last year.

There have been other items, again, extraordinary items, new funds coming into the business, tax credits at their record stockmarket rise, which produced enormous amounts of realized capital gains by historic standards. They have a positive result producing net income again but modest. Still less than 3 percent return on net worth.

Let me close by mentioning that we believe that the current insurance availability and affordability problems are in large measure an outcome of the present civil justice system in the U.S. But insurers have not been sitting idly by doing nothing. We have been working diligently over the past several years to develop a new modernized, simplified, commecial general liability policy form which we believe will respond to the current marketplace needs.

This new CGL program will offer a choice between two attractive alternative versions of a commercial general liability policy form. We expect that one of them, that is, the claims made form, will in fact increase the availability of insurance in those instances where the occurrence coverage simply cannot be underwritten or priced accurately.

We believe also this will help with the affordability problems that many insurers are facing. We do not suggest that this new program can or will solve all of the industry problems, or all of the problems of businesses today, but we do believe it is a positive step that is taken by the industry in these difficult times.

Thank you, Mr. Chairman.

[The statement follows:]

STATEMENT OF MAVIS A. WALTERS, SENIOR VICE PRESIDENT, INSURANCE SERVICES OFFICE, INC.

I am Mavis A. Walters, Senior Vice President of Insurance Services Office, Inc. I am a Fellow of the Casualty Actuarial Society and a member of the American Academy of Actuaries.

Insurance Services Office, Inc. (ISO) is a non-profit corporation that makes available rating, statistical, actuarial, policy form and related services to any U.S. property/casualty insurer. ISO is not a trade association and therefore does not routinely represent insurers in legislative forums. However, on occasion, we do serve as technical advisors to the property/casualty insurance industry and in that capacity may appear with trade association representatives before legislative bodies.

ISO has no mandatory membership requirements, nor do we have adherence requirements with respect to advisory rates, loss costs, policy forms or programs. In fact, we actively encourage independent action by participating insurance companies.

We serve participating insurers by gathering, storing, and disseminating statistical information to regulators, as required by law, and to insurers for their own use. We also develop and assist in implementing programs that help define and cover risk. We promulgate advisory rates or advisory prospective loss costs for sixteen lines of insurance including personal lines (automobile and homeowners) and commercial lines of insurance such as Commercial General Liability (CGL).

In order to put the present insurance availability and affordability problems into perspective, it is necessary to understand the overall financial condition of the insurance industry today. Since 1979, losses and expenses have exceeded premiums primarily because prices failed to keep pace with loss costs and lagged the nation's overall economic growth. As a result, an unbroken string of underwriting losses began in 1979 and grew at an average annual rate of $8 billion through 1983.

An even more dramatic increase took place in 1984 when underwriting losses jumped $8 billion, reaching $21.8 billion. Losses from underwriting for the six years 1979 through 1984 totalled a staggering $55 billion.

The poor overall results of the property/casualty insurance industry in 1984 were not felt uniformly in all areas of operations. The combined ratio, also called the trade ratio, is a useful tool to analyse the relative underwriting results of different segments of the industry. This combined ratio is the ratio of incurred losses, loss adjustment expenses, and policyholder dividends to earned premiums, plus the ratio of underwriting expenses to written premiums.

The combined ratios for all lines of business, counterwide, have exceeded 100 in each of the most recent six years. This means simply that losses and expenses have exceeded the premium collected for those years. Most alarming is that between 1983 and 1984, the growth of the combined ratios was the largest since 1973-1974. However, while the 1973 ratio was 99 and rose to 105 in 1974, the 1983 combined ratio already stood at the ominous level of 112 before leaping to an unprecedented 118 in 1984.

This deterioration in results has been led by the commercial lines. Historically, personal and commercial lines results have closely paralleled each other. Between 1967 and 1982, the difference between the combined ratios never exceeded 6 points. As recently as 1981, the ratios were only 2 points apart. Then in 1983, the gap grew to 12.5 points. In 1984, it expanded to over 20 points. These high ratios are of even greater concern than they would otherwise be because industry analysis agree that the commercial lines combined ratio is understated due to reserve inadequacy. Since many companies write mostly commercial lines business, the combined ratios for these insurers are much worse than they are for the industry as a whole.

The four key commercial lines of business experienced disastrous results in 1984. Medical Malpractice at 170, had the highest combined ratio. General Liability had the next highest at 152; Commercial Multi-Peril was 135; Workers Compensation stood at 122 and Commercial Auto Liability experienced a 144 combined ratio. Results for the first half of 1985 are not appreciably better. Medical Malpractice is at 169 and Commercial Auto Liability is still in the 140's at 142. G.L. is at 145.

Another segment of the industry which has been particularly hard hit has been the reinsurers. This is due in part to their heavy concentration in the commercial lines, but is due also to their particular susceptibility to very large losses and unusually adverse loss experience. For the past two decades, reinsurer results have closely paralleled those of the property/casualty industry as a whole. The gap between the combined ratios never exceeded 4½ points, except for the 6-point gap in 1965, the year of Hurricane Betsy. As recently as 1982, the two combined ratios

were only ⅒ of a point apart. The gap grew to 6 points in 1983 and then to 10 points in 1984.

While underwriting results have declined since 1979, the industry's net investment income has grown continuously. In an attempt to generate cash flow for investment, insurers competed aggressively for premium dollars, knocking prices more and more out of line with loss costs. However, the average annual investment income growth of $1.7 billion did not even come close to the average annual growth of $3 billion for underwriting losses from 1979 through 1983.

In 1984, the 10% increase in investment income of $1.6 billion was far below the 60 percent increase of $8 billion in underwriting losses. With investment income lagging far behind underwriting losses, the industry's pretax operating income—the combination of investment income and underwriting results—plunged to a nagative $3.8 billion in 1984. This figure, pre-tax operating income, is the primary component of insurer income and represents the pre-tax profits from insurance operations. It is this component of income which is responsible for the long term viability of the industry. The huge $3.8 billion loss in 1984 is the largest ever experienced in this industry. Although investment income has been rising gradually over the last several years, it is no longer able to offset the staggering underwriting losses which increased 60 percent in 1984 alone. Clearly, if the property-casualty insurance industry is to maintain its current capital base, let alone attract new capital to meet the insurance needs of a growing economy, the industry must improve its earnings. (See chart A attached)

A second measure of insurer profitability is the total rate of return on net worth. This measure includes operating income, realized capital gains, taxes and other miscellaneous income, and is often used to compare the profitability of insurance with other industries.

By this measure also profits in the insurance business declined in 1984 for the seventh consecutive year. The industrywide average rate of return on year-end adjusted statutory net worth (excluding unrealized capital gains) was only 1.7 percent in 1984.

Only record realized capital gains of $3 billion and tax credits of nearly $2 billion prevented net income after taxes from dipping into the red. Negative cash flow and tax considerations in 1984 made realization of long-term capital gains attractive if not necessary. But tax credits are rapidly disappearing, and capital gains of this magnitude cannot be relied on, particularly in light of the over $3 billion unrealized loss in 1984. Even with these accounting aids, 50 of the top 100 insurer groups' return on net worth was actually negative. Falling profits were experienced across virtually all segments of the industry.

During the period 1960 through 1984, insurers typically earned less than the average rate of return achieved by other industries in the United States. The annual rate of return on net worth for insurers has exceeded the Fortune 500 all-industry average in only five of the past eighteen years. In 1984, insurers' rate of return trailed that of the Fortune 500 by more than 11 percentage points. This is another indication of the rather fragile financial condition of the U.S. insurers. (See chart B attached)

Yet another ingredient adding to the poor financial condition of the insurance industry is the decline in policyholders' surplus. Policyholders' surplus is the difference between insurers' assets and liabilities and is a measure of an insurer's capacity to provide insurance coverage safely. This is the financial security, the uncommitted funds of an insurer that stand behind every insurance policy. It is this quantity that provides the necessary cushion to support the shock of major catastrophes, stock market declines and loss reserve inadequacies. As a result of operating losses in 1984, industry surplus fell 3% to $63.6 billion. In constant dollars, 1984 surplus was 3% below the 1980 level, which indicates that capacity may not be sufficient to meet the insurance needs of an expanding U.S. economy.

The 1984 drop in surplus would have been much worse were it not for the record-breaking influx of new funds into the industry. New funds represent additions to the capital structure of an insurance company. The two major sources of these funds are new stock offerings and contributions from non-insurance parents to insurance subsidiaries. Reasons for an addition to capital range from preventing an insolvency to expanding underwriting capacity.

Prior to 1984, new funds invested annually in the industry never exceeded $1.5 billion, averaging $1 billion over the last decade. However, in 1984, capital additions soared to a record high of over $3 billion. If 1984 new funds had been near average, the surplus decline would have been over twice as large as the $2 billion recorded.

Other action taken by the industry to preserve scarce surplus was a dramatic cut—21 percent—in stockholder dividends from $2.9 billion in 1983 to $2.3 billion in 1984. In addition, the industry benefited from a record federal income tax credit of $1.7 billion. These measures added an unexpected $3 billion to the industry surplus in 1984 thereby reducing the overall decline from almost $5 billion that had been estimated earlier to about $2 billion.

This decline in surplus has raised concerns about the solvency of many insurers. In 1984, at least 22 property/casualty insurance companies were found to be financially impaired. Most of these companies were insolvent. Additionally, several sizable insurers were placed in rehabilitation by regulators with an indication given that liquidation could not be avoided. In total for 1984, 418 property-casualty companies, representing 17% of the total number of companies filing annual statements were targeted for attention by insurance department officials.

A.M. Best Company annually conducts a specialized financial analysis of most United States insurance companies and expresses its evaluation in the form of a rating. All companies rated "Excellent" are considered to be outstanding and have no material unfavorable variances from A.M. Best's averages. Lower ratings reflect increasingly unfavorable variances from A.M. Best's industry standards. An "Excellent" rating is considered essential if an insurer wishes to do business with top U.S. corporations, municipalities and government contractors.

From 1982 to 1983, 30 companies' ratings were upgraded to "Excellent" while 78 companies' ratings were downgraded from "Excellent". In 1984, there were 38 increases to "Excellent", but 150 companies received rating decreases from this level. Because 1984 operations caused a sudden and dramatic decline in the financial condition of many top-rated insurers, further decreases are expected in 1985 as ratings are developed from 1984 financial statements.

The declining solidity of the P/C industry is also illustrated by what is termed the exposure ratio, defined as the ratio of net written premiums to surplus. The percent of industry premiums written by companies with high exposure ratios has increased dramatically. The National Association of Insurance Commissioners (NAIC) has selected a premium-to-surplus ratio of 3-to-1 as a maximum. Any insurer writing above this level fails the premium-to-surplus test. The percent of industry premiums written by companies whose premium-to-surplus ratio exceeds 3-to-1 has tripled since 1981, to almost 15 percent.

In early 1985 ISO released a study entitled, "The Coming Capacity Shortage," which projected that the available property/casualty insurance may fall short of demand by $62 billion over the next three years. This projection was based on a fairly stable financial scenario which indicated that the capacity shortfall could be even more severe if circumstances are less favorable than assumed.

The model used for the ISO study was based on actual results for the first three quarters of 1984 from which an estimate of 1984 results was made. However, some highly unusual developments since that study was completed indicate that the magnitude and severity of the current shortfall may be somewhat less than our analysis originally indicated. Nevertheless, we still are confident that the conclusion remains substantially the same, i.e., the demand for insurance exceeds the current available supply.

Aggressive and proper pricing actions now being taken will ultimately reverse the six-year deterioration in property-casualty returns on net worth. But these actions are bringing on new industry problems, which is part of the reason why we are here today.

Unfortunately, the first half of 1985 continues the unhealthy past pattern in many ways. The bad news is that operating income, as we had predicted, is still negative, by over $2 billion. On the other hand, the good news is that the industry continued to benefit from new funds, tax credits, and a record stock market producing an enormous amount of realized capital gains by historic standards. Without these unusually high contributions, surplus would have declined still further. Instead, the surplus growth of about $5 billion has enabled the industry premium to surplus ratio to remain at about 1.9 to 1, even with a healthy written premium growth of more than 17 percent for the first half of 1985.

If an insurer could estimate its costs accurately and pass these costs on to an insured in the form of premium increases, there would be no reason to deny coverage for any risk, within the bounds of the insurer's capacity to write insurance. But the fact is that the expansive tort liability system has created tremendous uncertainty in the ultimate costs of a liability contract. It is the near impossibility of determining actuarially sound prices in such a legal environment that has stopped insurers from insuring certain risks.

Consider some of the legal developments which have contributed to the disastrous underwriting results of 1984. In the area of Pollution Liability, insurers are being required to defend the indemnify commercial insureds for hidden or gradual pollution of the environment despite having explicitly excluded coverage for all but "sudden and accidental" losses. The use of medical presumption has been expanded to find liability when there has been no clearly established link between exposure and injury or damage. And strict, joint and several liability has been imposed on users of hazardous waste dump sites, not only for future insureds, but retroactively to apply to all past insureds.

In the area of Medical Liability, malpractice is increasingly being found whenever there is a bad medical result. There has been a radical expansion of government tort liability in the last 10 years, affecting Municipal Liability. And in the area of Products Liability, there has been a literal explosion of cases resulting from liability awards on products which:

Were built and sold decades before the injury,

Had "State of the Art" safety features and technology at the time they were manufactured,

Had safety devices tampered with or removed,

Were not used for their intended purpose,

Were accompanied by warning labels and safety instructions;

Were not proven to be harmful, and

Were not even proven to be made by the defendant.

Given the uncertainties involved in trying to anticipate the legal environment even a few years hence has made reasonable actuarial pricing all but impossible for some risks. The expansive interpretations affecting any area of tort liability are likely to find application in other areas as well, making even the so-called profitable risks of a few years ago potentially uninsurable.

In recognition of the enormous problems facing insurers and policyholders alike, ISO and its participating companies have been working diligently over the past several years to develop a new simplified, modernized commercial general liability policy form to respond to current marketplace needs. The new Commercial General Liability Policy is the first major revision for this line of insurance since 1966.

This policy form is the result of years of effort and the most extensive industry review of a new policy form in ISO's history. ISO distributed more than 1,500 copies of an exposure draft to a broad cross-section of industry interests—nearly 250 groups and individuals in all—for their review and comment. Insurers, producers, buyers, reinsurers, educators, lawyers, risk managers, adjustors, consumers and trade associations all provided advice, and more than 30 organizations reported the suggestions and reactions of their members.

Of course, not every suggestion could be adopted, because some were diametrically opposed to one another. But ISO considered every single suggestion, and the policy we are introducing reflects many changes—big and small—made as a result of the industrywide review.

The new CGL Program offers a choice between two attractive alternative versions of a Commercial General Liability Policy form.

One version, the "occurrence" version, provides coverage for bodily injury and property damage that occurs during the policy period. The other version, the "claims-made" version, provides coverage if the claim for damages because of bodily injury or property damage is first made during the policy period. The only differences between the two versions of the policy form are in the provisions related to what activates or triggers coverage.

The "occurrence" trigger is provided in recognition of continued marketplace demand for a modern "occurrence" form. The "occurrence of injury or damage" language that triggers coverage in the new policy is essentially unchanged from the coverage trigger in the policy it replaces.

The claims-made language for triggering coverage is a brand new alternative. The "claims-made" policy's unique features that assure reliability of coverage make it unlike any other claims-made policy now in use. The introduction of this "claims-made" trigger—and the continued availability of an "occurrence" trigger, too—calls for informed judgment and a rational assessment of the alternatives by insurers, producers and ultimately, by consumers.

The need for these changes can be summarized as follows:

1. Litigation relating to the existing "occurrence" policy has been costly and time-consuming. For the most part such litigation—which continues to go on to the detriment of insurers and policyholders—has centered on latent bodily injury and long-term exposure issues involving substances such as asbestos and DES. A key issue in dispute is: When did the injury or damage occur? That's extremely important in the

context of insurance because the answer determines which "occurrence" policy or policies apply. Litigation over that question is likely to affect more and more insureds of all sizes in all types of business, as new cases arise where the time when bodily injury or property damage occurred is at issue.

2. Many insureds have to rely on policy limits provided by old "occurrence" policies to respond to current claims, because the injury or damage may have occurred long before the claim is made. Those old policies may have been purchased many, many years before claims emerge, settlements are reached and judgements rendered—and years before inflation eroded the value of the old policies' limits.

3. Some courts have adopted legal theories in latent-injury or long-term exposure cases, which hold that injury occurred during a long series of "occurrence" policies. That leaves many contracts-and sometimes many insurers-with primary defense and indemnity obligations for a single claim. Often, such situations arise when there are many claims for similar or related injury. As a result, insurers don't know how much is at stake, and for how long, under these contracts. That makes it difficult to determine accurate premiums and loss reserves. And beyond that, such "stacking" of limits poses a serious threat to the very solvency of some insurers. In view of this, some insurers and reinsurers have become increasingly reluctant to handle "occurrence" coverage. Without some change, there could be a real insurance-availability problem.

4. Under the existing policy form, the only limit that applies to some parts of the coverage is a per-occurrence limit, so the insurer's liability for injury that occurs during the policy period increases with the number of "occurrences" held to have produced the injury. That liability could be astronomical, depending on how courts interpret the term "occurrence." Stacking per-occurrence limits within a single policy further threatens insurance availability and insurer solvency. (The existing policy form does, however, put aggregate limits on many parts of the coverage, including products and completed operations.)

5. Some courts-after long and costly lawsuits-have interpreted the "sudden and accidental" exception in the existing policy form's pollution exclusion so broadly that insurers and reinsurers are exposed to unknown but potentially gigantic losses totally unforeseen when existing policies were written or priced. Moreover, pollution coverage is particularly vulnerable to all the "occurrence" issues arising under the existing policy form. Because pollution-related damage or injury is often latent, there can be many causes of the injury, and there may be no aggregate limits on the coverage.

6. Need exists to consolidate and modernize ISO's advisory commercial general liability policy forms. Today many forms are needed to provide the scope of coverage that most buyers consider standard.

7. To improve efficiency and reduce costs, the existing policy forms, manual rules and rating procedures need to be streamlined and made more adaptable to automated policywriting.

8. Insurance buyers and regulators want more readable and understandable insurance contracts for all lines of insurance.

We expect that the availability of a claims-made policy will increase availability of insurance in those instances where occurrence coverage simply cannot be underwritten or priced accurately, and will allow insurers to price their products more accurately.

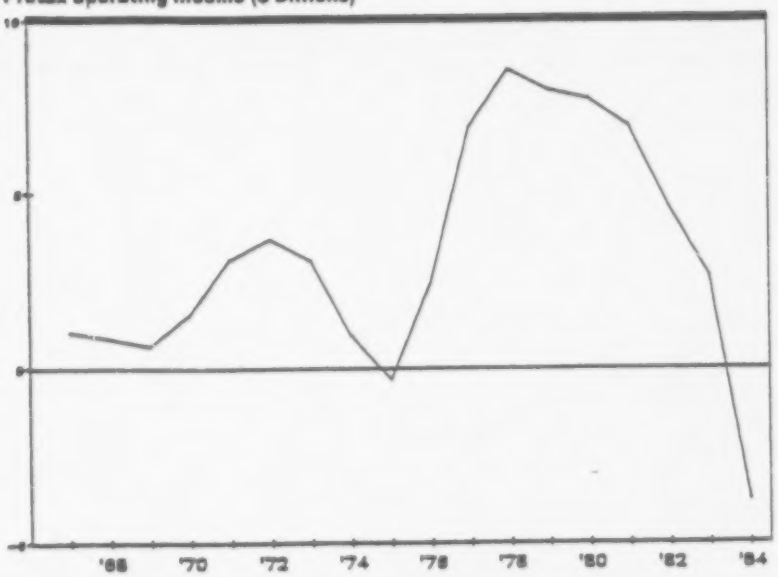
To the insured who presents a difficult exposure, either because of his own particular circumstances or the business in which he is engaged, the availability of a claims-made contract may mean the difference between getting insurance or having no insurance at all. Even for a typical, non-problem risk, the claims-made option can mean significant premium reductions and offer the insured the ability to keep his limits of liability insurance up-to-date. We see no reason to deny these advantages to any insured, and believe that the approval of this program on a country-wide basis is truly in the best interest of the insuring public and to the insurance industry alike.

We do not suggest that the new CGL program can or will solve all of the insurance availability or affordability problems of today's marketplace but we are confident that it will be seen as a positive step taken by the industry in these difficult times.

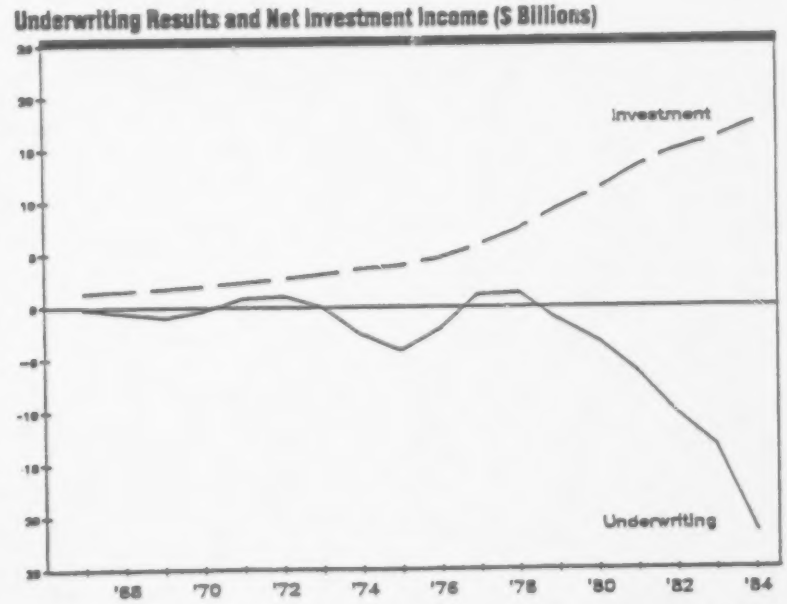
Operating Results

Attachment A

Pretax Operating Income ($ Billions)



Underwriting Results and Net Investment Income ($ Billions)

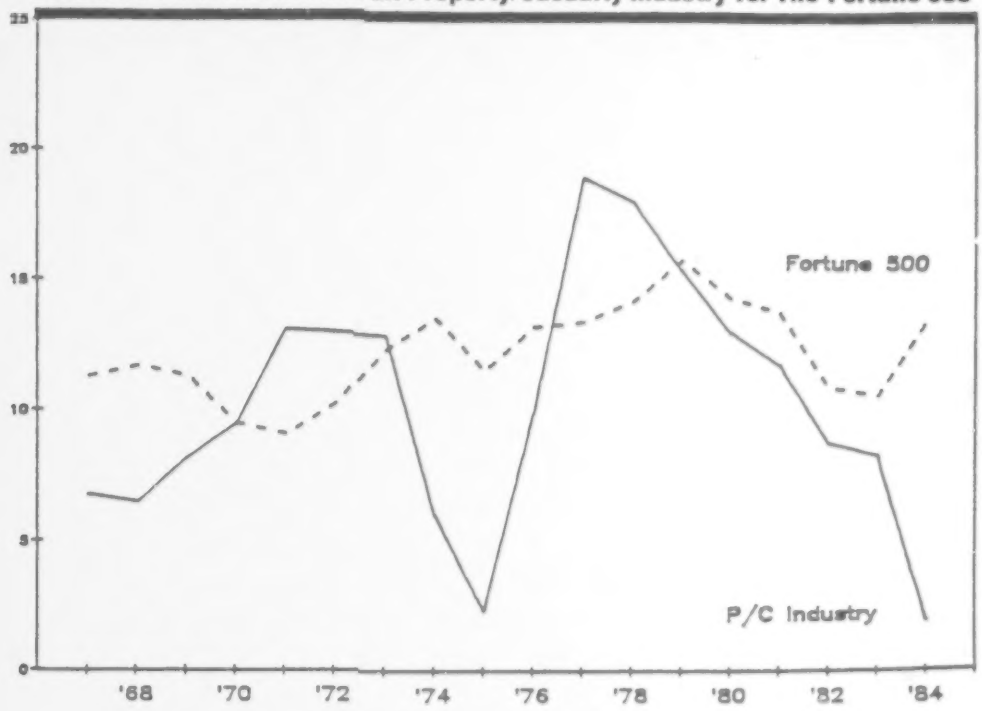


Source: ISO 1985, A Critical Year

Attachment 8

Rates of Return

Return on Year-End Net Worth: Property/Casualty Industry vs. The Fortune 500



Profits in the insurance business declined in 1984 for the seventh consecutive year and plummeted to their lowest point in at least twenty-five years. The industry-wide average rate of return on year-end adjusted statutory net worth (excluding unrealized capital gains) for the year is estimated at only 2%. Only record realized capital gains of nearly $2 billion prevented net income after taxes from dipping into the red. Negative cash flow and tax considerations in 1984 made realization of long-term capital gains attractive, if not necessary. 50 of the top 100 insurer groups' return on net worth was actually negative.

During the period 1967 through 1984, insurers typically earned less than the average rate of return achieved by other industries in the United States. The annual rate of return on net worth for insurers has exceeded the Fortune 500 for all-industry average in only five of the past eighteen years. In 1984, insurers' rate of return trailed that of the Fortune 500 by more than 11 percentage points. This was the largest gap between these rates of return since at least 1976.

Source: ISO 1985, A Critical Year

[The following information was subsequently received for the record:]

QUESTIONS OF SENATOR PRESSLER AND THE ANSWERS

Question. As I mentioned in my opening statement, I have been somewhat frustrated by the lack of any hard evidence linking liability insurance rates to the tort laws in particular states. Could ISO develop information in this area such as:

(a) The relationship between tort laws in a particular state, focusing on the five states the industry feels have the most favorable tort laws, and the five states the industry feels have the worst tort laws;

(b) The percentage of claims paid that were the result of court awards;

(c) The relationship of court awards paid under particular lines of coverage to premiums in those lines.

Answer. Unfortunately, the questions raised here cannot be answered in any meaningful way. The relationship between tort laws, insurance losses and claims and insurance premiums is far too complex to permit a relatively simple analysis such as is suggested here.

To elaborate: insurance premiums for various coverages are a function of many elements, the more important being the cost and frequency of claims for those coverages in a given state as well as the competitive market in that state. The incurred losses, produced by claim costs and frequency will be affected by the general cost levels within the state. For example, hospital and medical costs, wage levels, auto repair costs, building costs, labor costs, all the costs of doing business and the costs of things for which insurance pays will influence insurance premiums in a state. Consequently, one would not be surprised to see high premiums in states like New York, New Jersey, Pennsylvania, Michigan, etc. heavily industrialized states with a high cost of living. But it is not *necessarily* valid to conclude that those or any other high premium states have "the worst tort laws". On the other hand a state with a relatively lower cost of living and lower premiums is not necessarily one without tort law problems. The analysis is just not that simple.

Furthermore, since most claims are settled prior to a court award any variation in the percent of claims settled after court award in different states is likely to be small and not meaningful. Insurer's claims supervisors and claims managers know the environment in which they are dealing and make their judgments according to those different environments with the objective of settling claims fairly. This does not necessarily mean resisting all settlements even in "the worst tort law states", particularly if they realize that they are likely to lose in court anyway.

Finally, the relationship of court awards to premiums is not necessarily a distinguishing factor between "favorable" and "unfavorable" tort law states either. In most instances we would expect the proportion of claims paid after a court decision to total earned premium to be relatively small since most claims are settled prior to that point. Regardless, this type of information is simply not available.

Although we can not provide the information you have requested, let me advise you that a working group from the major property-casualty trade association, including the producer organizations and Insurance Information Institute is in the process of developing what we hope will be very informative and useful information in this regard. We all recognize the need to demonstrate that the current tort liability system is no longer functioning the way it was intended in order to argue effectively for changes. The document that is in preparation will address that need. We will see to it that a copy is presented as soon as it becomes available.

Question. ISO predicted a 7 billion dollar shortfall of liability insurance coverage in 1985. How accurate was that prediction, and what is the predicted shortfall for 1986 and beyond?

Answer. In early 1985, Insurance Services Office released its study: "The Coming Capacity Shortage". That study, based upon preliminary estimates of 1984 results, concluded that available property-casualty insurance would fall short of demand by some $62 billion over the three year period 1985–1987, with more than 90% of the shortfall in commercial lines. $7 billion was the estimated shortfall in 1985, $22.6 billion in 1986 and $32 billion in 1987.

By mid 1985, when the actual 1984 results became available, it become clear that some of the underlying assumptions of our earlier study were no longer valid. For example, realized capital gains were extraordinarily high by historic standards and new capital came into the insurance industry by a much greater amount than could possibly have been anticipated. Consequently, the actual decline in surplus in 1984 was not as great as we had originally estimated. As a result, the magnitude of the

capacity shortage may be somewhat less than our original estimates. Nevertheless, our conclusion remains substantially the same: the current demand for insurance outstrips the available supply and this shortfall is being experienced in the commercial lines.

Since there is a recognized imbalance between the current demand for insurance and the available supply, this results in the suppliers (insurers) seeking to put their limited capacity to its best use, i.e. by writing insurance for those risks, for those coverages that insurers believe provide them with the greater likelihood of making an operating profit. At the same time, insurers will avoid writing insurance for those exposures that they view as highly risky and less likely to provide the opportunity to make an operating profit. In addition, the tight market conditions mean that insurers are seeking prices that they view as adequate to cover anticipated loss costs. There is no longer any competition for inadequately priced business.

Question. The insurance industry experienced one of its worst years ever in 1984 and the bottom of this latest cycle is deeper than previous bottoms. A new low, however, does not necessarily mean there is something fundamentally different in this cycle from all previous cycles.

Why is this "crisis" different from the medical malpractice and product liability crisis of the mid-70's, especially since after that cycle the insurance industry went on to post record profits?

Answer. There are many ways in which the current cycle is significantly different from the past experiences. The first and most obvious difference is that the most recent downturn had been longer and deeper than in past cycles (1969 and 1975). Furthermore, the low point (1984–1985) of the most recent cycle was different from past low years in several important respects. In both 1969 and 1975, the personal lines' results were worse than commercial lines' results. This time it is the reverse. The short tail, class-rated characteristics of personal lines means that insurers can recover more rapidly, while the long tail of commercial lines losses causes the current downturn to be more severe with the recovery taking a much longer period of time. In addition, the present downturn has affected virtually all of the commercial lines rather than being limited to one or two sub-lines such as medical malpractice and/or product liability.

Another factor that influenced the current downturn was the excess capacity in the reinsurance market. During the early 1980's many new non-traditional entrants into the reinsurance business made available large amounts of reinsurance at very low prices. As a consequence, reinsurers showed much more adverse results than the industry as a whole in 1984. The combined ratio for reinsurance was 10 points worse than the industry total. This is due in part to their heavy concentration in the commercial lines, but also reflects their particular susceptibility to very large losses and unusually adverse loss experience. Over the last two years, more then 90 reinsurance providers have withdrawn partially or totally from the U.S. market, and over 20 of these withdrawals were involuntary.

Finally the decline in surplus which characterized this last cycle was caused by significant operating losses while the 1969 drop was caused by a stock market decline. For the first time in decades, the decline in surplus was not accompanied by an overall stock market slump.

All of these differences will make recovery from today's downturn markedly different and longer than the last two.

Question. If we do nothing, how long will it be before the market returns to a more stable condition?

Answer. The market conditions affecting insureds will vary depending upon the type of exposure and coverage desired. In general, however, for the remainder of 1986 and into 1987 it is only reasonable to expect that premiums will continue to increase although at a lesser rate than 1985's 20% growth rate. Once operating income turns positive-which we do expect to occur in 1986-availability problems should alleviate somewhat and premium increases are expected to be more moderate.

The availability of the new ISO Commercial General Liability claims made policy form during 1986 will also serve to enhance availability for some otherwise difficult to insure risks and its initial premium discount over the occurrence form will make the price more affordable.

Of course, this is not to say that all those who want to purchase insurance will be able to do so in the amount, and at a price that they believe is reasonable. Those with a pollution exposure, for example, are likely to experience extremely tight market conditions for some time to come.

With respect to insurance companies themselves, at the Annual Meeting of Insurance Services Office, Inc., on January 14, 1986, our President, Daniel J. McNamara

referred to a new ISO analysis to be published shortly indicating that the recovery will need to be much longer and stronger than in previous years to repair the insurance industry's severely damanged financial structure.

ISO's analysis was based on several scenarios, the first of which simulated the 1976 and 1977 recovery. While premium and loss growth figures for 1985 closely match those of 1976, the soft market that appeared in 1977–1979 would mean no recovery at all if repeated in 1986–1988. Instead of the last recovery's near 20% returns on net worth, industry returns would instead peak this time at 9% and then drop to 3% in 1988.

Since only a two year recovery would be disastrous we focused on a second scenario that might produce an industry rebound lasting at least four years. Based on a set of reasonable assumptions this scenario would produced operating income (the combination of underwriting and investment income) reaching $5 billion dollars in 1986. Operating income will continue to rise to $8 billion in 1987 and $11 billion in 1988. However, the industry return on net worth will still be only 8.6% in 1986, 9.9% in 1987 and still under 11% in 1988. Even after four years of recovery the industry's return on net worth would still be well below the recent average return for the Fortune 500 companies.

The analysis indicates that significant variation in individual insurer performance will continue and some companies will never recover.

Question. Is it possible that the insurance industry is trying to make up all of its 1984 3.8 billion dollar operating loss in one year?

Answer. Insurance companies do not recoup or "make-up" past losses. The $3.8 billion dollar pre-tax operating loss in 1984 can never be recovered.

As a result of the aggressive competition over the past several years insurance premiums have not kept pace with loss levels. While premiums have been decreasing over the past several years, loss costs have continued to increase. By raising prices today insurers are not attempting to recover those past losses but rather to collect sufficient income to cover the loss costs which are expected to be incurred under today's policies! The distressed financial condition of property-casualty insurers currently will no longer permit them to inadequately price the business that they are writing. They must charge prices sufficient to cover anticipated losses so that they can eventually return to a profitable position.

Question. Does ISO have a breakdown on what types of organizations or businesses were subject to those 360 million-dollar-plus awards in 1983? How many of those awards were appealed, or is that 360 a post-appeal figure? How does this compare to 10 years ago?

Answer. We have been the references to the 360 million-dollar-plus awards in the media and in some background materials distributed by the Insurance Information Institute. We have no details concerning those figures, but suggest that perhaps the III might be able to answer these questions.

Question. How does the insurance industry determine rates? Are rates set on a state-by-state or nation-wide basis? What is the relationship between claims incurred and premiums charged?

Answer. Insurance rates or rate levels for almost all lines of insurance including passenger auto, homeowners, commercial auto or the general liability sublines are determined on a state-by-state basis by reviewing the loss experience in that state for each of the lines and coverages. In addition, there are usually territorial distinctions made within a state so that different geographical areas such as major cities and towns and rural areas will have different applicable rates based upon their relative loss experience compared with the state-wide average. Product liability rates, however, are made on the basis of countrywide experience because of the necessity for a countrywide data base for statistical credibility and because of the obvious ability to transport and use products all over the country.

Classification relativities, on the other hand, i.e., the relationship between and among different rate classes, are determined on the basis of countrywide data. This means, for example, that while the rate *relationship* between grocery stores and hardware stores would be the same in South Dakota as in, say, Pennsylvania, the rates for both types of stores in South Dakota are probably well below the rates for those stores in Pennsylvania.

It should also be recognized that the *prices* or *premiums* charged in the marketplace can, and often do, vary significantly from the *rates* as developed and distributed by an advisory rate organization such as ISO, or even rates filed by an independent insurer. Insurers frequently deviate from ISO rate levels, (most often down, not up), and have independent programs particularly for package policies which are independently priced. In addition, the use of experience and schedule rating programs provides a great deal of flexibility to the underwriter in his assessment of the un-

derlying exposure and appropriate prices to charge each individual risk. In some instances the actual incurred losses for a particular risk may be used, to the extent credible, in the individual risk rating programs. However, the absence of a claims history does not indicate that claims will not occur in the future. This is one of the reasons that insurance is purchased, since no one can predict with certainty if and when claims will be incurred for any individual risk.

Finally, competitive strategies, marketing considerations, growth and market share priorities and other factors can influence an individual insurer's perspective or judgment regarding the appropriate price to quote for a commercial risk.

Question. My towns in South Dakota complain that, despite what are generally very good claims records, their premiums continue to skyrocket, and in many cases they cannot find insurance at any cost. How does the claims records of a municipality affect the permiums paid for coverage?

Answer. Insurance costs and insurance prices for municipalities are increasing. We are also aware of growing availability problems for governmental entities. The attached four exhibits contain the most recent available countrywide data for municipalities which should demonstrate how unfavorable the experience has been. These four exhibits display the experience for governmental subdivision, public schools, streets and roads, and all municipal classes combined which is the sum of the experience of the three preceding exhibits.

As you will note, the experience for these classes was quite unfavorable in 1980 and has deteriorated further since then. As of the latest year insurers were incurring over $2 in loss and expenses for every $1 of premium earned. While comparable data for South Dakota alone is not as readily available there is no reason to believe that the trend toward ever worsening loss experience would be any different. All over the country governmental entities have become increasingly popular as deep pockets to fund payments to injured parties. Although historically municipalities were largely immune from lawsuits because of sovereign immunity, courts have been interpreting this as inherently unfair and laws have been changed to allow citizens to seek compensation for injuries resulting from negligent or willful acts of government.

The municipal liability classes are (a) rated rahter than manual rated which means that the determination of the appropriate rate must be left to the judgment of the individual underwriter based upon his evaluation of each governmental entity. As actuarial evaluation of all municipal classes is not appropriate and is not used to develop manual rates for this class since each municipality must be evaluated on the basis of its own characteristics. however, the past claims record is only one of the factors which will be used in the determination of premiums to be paid in the future for any individual municipality. Those municipalities with a bad claims record are likely to pay higher premiums than others. However, the absence of a poor claims history does not guarantee that future claims will not arise, particularly since sovereign immunity used to preclude the filing of claims. In determining premiums to be paid for future coverage underwriters must evaluate the current and prospective claims environment to determine how much premium will be needed to cover those future claims. In making that evaluation underwriters can't help but be aware of the increasing tendency all over the country for governmental entities to be found liable and to be forced to pay sizeable awards. Admittedly the judgments are of necessity somewhat subjective but the experience included on the attached exhibits clearly demonstrates the deterioration over the past several years.

Question. How does the agreement between a primary insurer and a reinsurer affect the coverage and premiums offered by primary insurer?

Answer. "Reinsurance is essetially an insurance transaction whereby the reinsurer, for a premium, agrees to indemnify the ceding insurer or reinsured against all or part of the loss which the latter may sustain under its policies of insurance. It is often described as the insurance of insurance companies because it provides reimbursement for an insurer's losses under policies covered by the reinsurance contract. Reinsurance is purchased by the primary or excess ceding insurer for its own benefit so that it can spread its risks and limit its own liability from large or catastropohic losses. The usual reinsurance contract does not involve the plicyholder, who looks only it its insurer defense and indemnity against loss.

Reinsurance was developed to provide capacity essential to the continued growth of the direct insurance industry. In addition to capacity, reinsurance is purchased by a primary insurer to (1) reduce exposure to liability on particular risks, (2) protect against accumulations of losses arising out of catastrophies, (3) reduce total liabilities to a level appropriate to its premium volume and capital, (4) reduce exposure to certain and possible more hazardous lines of business or alter its "mix" of

business, (5) help stabilize operating results, and (6) obtain assistance with new concepts and lines of insurance.

Reinsurance contracts are shaped to meet the specific needs of the ceding insurer and although there are no standard reinsurance contracts, there are two basic types which are used and adapted to accommodate the buyer's business. A reinsurance *treaty* is a broad and often automatic agreement that covers some portion of a particular class or classes of business, i,e., the ceding insurer's entire workers' compensation or property book of business. In contrast, a *facultative* agreement covers a specific risk of the ceding insurer and requires the insurer and reinsurer to agree on terms and conditions on a contract-by-contract basis. Both treaties and facultative agreements may be based on a *pro-rata* distribution where the two parties share proportionately in premiums and losses. The agreements may also be written on an *excess* basis, where only the losses of the insurer in excess of a predetermined amount, known as the "retention", are reinsured."[1]

It must also be noted that many reinsurers also provide *direct* excess insurance to policyholders, although this direct business generally represent a small portion of a professional reinsurer's entire book of business.

The amount of reinsurance coverage and the cost of that coverage to the primary insurer does of course, affect the amount and cost of insurance that can be available to policyholders. The reinsurance industry's dismal financial results of 1984 with a combined ratio of 128, has resulted in a restriction on the amounts of liability coverage available to primary insurers as well as higher prices to primary companies. This in turn has reduced the amount of coverage the primary insurers can offer policyholders and it has raised the costs.

Question. The current problems in the insurance industry have been attributed to poor underwriting practices, shortcomings of the civil justice system, and the cyclical nature of the industry.

Could you please rate on a 100 point scale, the relative importance of those three factors, or any additional factors, as causes of the current "crisis"?

Answer. While recognizing that this question calls for highly subjective answers I would suggest that such answers would vary for different coverages and lines of insurance. For example, the current problems associated with pollution liability insurance I would characterize as almost entitely associated with current federal requirements, legal and regulatory, and the unpredictability or unreliability of today's civil justice system. At the other end of the spectrum, day care liability problems are probably more a reflection of a perceived change in the underlying exposure as a result of the recent publicity given to numerous child abuse cases. Listed below are my subjective evaluations of the importance of various factors on a current availablity, affordability problems by types of risks.

Class of business	Underwriting practices	Civil justice system	Insurance cycle	Other
Day Care	5	10	5	80
Liquor Liability	10	80	10	
Medical Malpractice		90		[1] 10
Pollution		90		[2] 10
Municipalities		85	5	[3] 10
Commercial Auto (Trucking)	30	30	30	[4] 10

[1] Ineffective discipline.
[2] Scientific advances.
[3] Competitive bidding.
[4] Competition in industry; federal insurance requirements.

Question. What specific actions can or should governments take to correct the insurance crisis, and should the action come from the state or federal government?

Answer. This question is beyond the jurisdiction and responsibility of Insurance Services Office. All of the property-casualty trade associations have developed position papers outlining their specific recommendations and I am certain that they would be pleased to share those with you.

Question. What percentage of the insurance industry's annual expenses is defense costs?

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[1] Reinsurance Association of America Statement—House Subcommittee on Commerce, Transportation and Tourism, September 19, 1985.

Answer. Insurance Services Office has recently completed a special study of the legal defense costs associated with general liability insurance. An historical analysis of allocated loss adjustment expenses (90 percent of which are legal fees) indicates a dramatic and steady increase compared with insurers payments to injured parties. Loss adjustment expenses were between 10 and 15% of insurance company losses in the late 1950's rose to 25% of losses in 1970, but by 1984 such expenses had jumped to 36 percent of losses. In total in 1983 the property-casualty industry incurred a staggering $4.2 billion in defense costs with general liability accounting for nearly half this amount. General liability defense costs are now growing about twice as fast as loss payments, increasing 140 percent from 1978 through 1984.

Our projections are that when claims reported in 1983 and 1984 are finally settled, their defense costs will approach 50% of payments to injured parties. Additionally, if defense costs continue to grow at their present rate of 12% annually, $19 billion of defense expenses will be incurred between 1987 through 1991.

Question. Have insurance premiums decreased in any states that have capped certain types of civil damage awards?

Answer. The effect of caps on certain types of civil damage awards is very difficult if not impossible to measure, as it relates to insurance premiums. Since insurance premiums are driven by both the cost and frequency of claims as well as competitive and marketplace forces the interaction of all these elements makes it almost impossible to isolate any single one. For example, if competitive and/or regulatory factors resulted in premiums being *inadequate* before the caps on damages were effective it is not likely that premiums would decrease from that level because of the cap. Additionally, if claim frequency were on the increase and the effect of inflation was making the average claim severity also grow then a cap on only the largest (though infrequent) awards would be minimal. Under such circumstances one would not expect premiums to decrease either. All we can say with any certainty is that if *effective* measures are taken to limit the increase in losses which will be paid by insurers then the resulting premiums will be lower than they would otherwise have been in the absence of those measures. Additionally, it is likely that underwriters with a limited capacity to write insurance are far more likely to make that insurance available in jurisdictions which have taken steps to minimize catastrophic sized awards than in jurisdictions lacking such limitations.

The informational material being developed by the joint trade association working group may be helpful in providing more definitive answers to what has happened in those states that have enacted certain types of tort reform.

Question. Could you provide us with information that tracks the change in premium price levels in the various lines of commercial property/casualty insurance over the last several years? How do those changes compare to the consumer price index?

Answer. In response to question 7 we made a distinction between insurance prices or permiums and insurance rates. While there is no definitive way to track actual insurance prices over the past several years, ISO does maintain a rate level history for those lines of insurance for which we review and/or file rates for our participating insurers. The significance of the ISO advisory rate activity is that these rate level changes are overwhelmingly a function of loss cost changes which have occurred over the years. If the premium actually charged by insurers kept pace with these changes then those premiums could reasonably be expected to be adequate to cover anticipated losses.

Although there is no definitive source for insurance company price activity over the years, the change in the level of written premiums as compiled by A.M. Best may serve as an imperfect but somewhat reasonable proxy. Written premium volume will be affected by the number of insured exposures and the amount of coverage purchased as well as by changing rate or price levels. For example, during the 1980's with the advent of trucking deregulation, the entrance of hundreds if not thousands of new competitors and the federal requirements for high levels of insurance coverage might have been expected to produce a noticeable rise in written premium for commercial auto insurance over this period. The fact that this did *not* happen, but rather premiums remained flat or even decreased, tells us that average *price* levels actually decreased and no doubt *substantially* during this time period. We would further not that the ISO advisory rates increased at a healthy pace during those same years while actual prices were obviously decreasing. This indicates that today's inadequacy in prices is no doubt very substantial.

The table on the following page displays written premium changes and ISO advisory rate activity during the last several years.

[Dollar amounts in millions]

Year	Commercial auto			General liability				
	Written premium	Percent change	ISO advisory rate change (percent)	Written premium	Percent change	ISO advisory rate changes		
						OL&T [1]	M&C [2]	Prod. [3]
1981	$7,297	−0.1	+14.2	$5,944	−6.5	+14.9	+0.6	−5.9
1982	7,299	.....	+11.5	5,594	−5.9	+21.0	−0.1	+6.4
1983	7,364	+0.9	+7.6	5,599	+0.1	+10.3	+18.4	−3.9
1984	8,519	+15.7	+12.6	6,404	+14.4	+16.8	+16.3	+9.1
1985	[4] 10,623	+32.9	+12.6	[4] 9,870	+61.9	+35.7	+29.4	+20.3

[1] Owners, Landlords and Tenants.
[2] Manufacturers and Contractors.
[3] Product Liability.
[4] 9 months.

Question. Will the various tort reforms advocated by the insurance industry translate into lower premiums for insurance buyers?

Answer. It is virtually impossible to claim that the price of insurance will decrease from today's levels as a result of legislative or judicial action. The fact is that 1985 premium levels, although they represent a substantial increase over 1984 premiums, are still inadequate to cover anticipated loss costs. Further increases will be necessary in order to bring prices more in line with loss costs and to produce an acceptable level of profitability for insurers. Tort reform will not alleviate the need for price increases today because the loss levels are still in excess of price levels. Preliminary estimates of 1985 results indicate a further substantial pre-tax operating loss for the property-casualty industry with estimated returns on net worth in the low single digit range.

While insurance premiums are not likely to decrease as a result of tort reform, the increases needed in anticipation of future losses might be somewhat less if defense costs and frequency of claims were to become more stable and predictable. And, as stated in response to question 13, premiums are likely to be lower than they would otherwise be, in the absence of tort reform.

Medical science can diagnose or locate the potential for causal relationships in these areas, but it has not reached a point of meeting the legal standards of preponderance of the evidence. The result is juries and judges have strained to close that gap between the legal standard and what medical science can prove, and they have done that by introducing presumptions, reducing evidentiary procedures, and in some instances misinterpreting our contract language in the courtroom.

Secondly, Federal financial responsibility requirements have exacerbated the problem. Coincidental with the capacity problems and drain on surplus which Mavis Walters has mentioned, the judicial misinterpretations of our contracts, particularly in the area of pollution exposures, and the expansion of liability concepts, there have been four Federal laws which have either been enacted or in which the rulemaking process has been finalized which mandate financial responsibility requirements for a set of policy holders.

The notion associated with financial responsibility requirements is that the insurer will act as a surrogate regulator. If you make the acquisition of insurance a prerequisite for doing business, the notion goes, then the insurer through its underwriting process will eliminate the bad risk.

The notion simply does not work, particularly in an insurance crisis such as we have today. The four laws which I mentioned are CERCLA, that is Superfund, the Motor Carrier Act, the Bus Regulatory Reform Act, and the Resource Conservation and Recovery Act. All four of these laws mandate a minimal level of insurance in order to do business in a particular area.

With respect to the Motor Carrier Act, if you carry extra-hazardous substances, or the Bus Regulatory Reform Act, if you have a seating capacity in excess of 15, then the minimum insurance requirement is $5 million. So these minimum mandatory insurance requirements have exacerbated the other problems which have created the current insurance situation.

Thank you.

[The statement follows:]

STATEMENT OF THE AMERICAN INSURANCE ASSOCIATION

The American Insurance Association (AIA) is a trade association which represents 177 property and casualty insurance companies. The member companies of the Association provide the majority of the liability insurance coverage written throughout the United States. We have been asked to present testimony associated with the scope of the availability and affordability of liability insurance problem currently being experienced by the purchasers of insurance.

Insurers are exhibiting neither panic nor hysteria by taking a conservative stance on writing certain lines of commercial liability coverage. Rather, they are being prudent in the face of unprecedented losses and a rapidly changing operating environment.

UNDERLYING CAUSES

The liability insurance availability/affordability problem is primarily caused by the structure and operation of the tort liability system rather than by temporary market dislocations. Tort liability and insurance elements such as causation, latency, identity of defendants, fortuity and size of risk must be examined in order to categorize lines of insurance as insurable or uninsurable.

The most basic concept underlying insurability and insurance contracts is the concept of risk. "Risk" means literally the "chance of loss" or the "probability of loss." If a loss is certain to happen, then there is no risk of loss to transfer, and an insurance transaction cannot take place. There is a growing perception among underwriters that the accumulation of legal remedies provided under state and federal liability systems are changing a hitherto insurable probability of loss to an uninsurable, virtual certainty. Underwriters are attracted to predictability of loss but must avoid inevitability of loss.

The second basic fundamental of underwriting and insurability is that of predictability. If there is no way to forecast the timing or amount of a loss from past experience, then the loss is unpredictable. Any estimate would be pure speculation.

Standard coverage for liability insurance originally applied to bodily injury or property damage "caused by accident". The accident concept was also the time trigger of coverage and the building block of limits of liability. An individual policy covered only accidents which occurred during the policy period.

The classical accident, as perceived by insurance underwriters and policy drafters, was concrete, rather than abstract. They regarded in "accident" aa a sudden event of a physical nature that happened by chance at a definite time and place and caused rather obvious injury or damage a collision of vehicles, a scaffold which broke, a roof which collapsed. "Accident" was not a legalistice concept. The underwriters' conception of "accident" harmonized well with both the classical liability principles of tort law and the fundamentals of insurabilty. Certainty as to time and place laid the foundation for reasonable predictability.

By 1970, it became apparent that coverage based solely on the classical accident concept was no longer adequate for most insureds. There were true "risks of loss" that did not arise our of suddern causes, but were the result of continuous or repeated exposure to physical causes which resulted in nontraumatic, multiple causation, long-latency diseases.

The extent of exposure for liability insurance coverages has changed dramatically in the past decade. The relationship between low level exposures to useful, but sometimes harmful substances, and injuries to human beings is not well understood today and is still to a large extent speculative. Tort law a few years ago did not concern itself with speculative possibilities or harm. Doctrines of joint and several enterprise liability has not been formulated. It was not until 1974 that the deluge of asbestos-related claims began.

Recent court decisions have created new and unpredictable liabilities for property/casuality insurers. As stated in the Villanova Law Review:

"In two recent toxic tort cases, the highest courts of California and New York have held that liability for injuries allegedly caused by DES can be imposed upon defedant-manufacturers without proof that those defendants made DES which caused the plaintiffs' injury. In *Sindell* v. *Abbott Laboratories* (1980), the California Supreme Court accomplished this result by fashioning a "market share" theory of liability. Under this theory each defendant was liable for the proportion of the judgment represented by its share of the DES market unless the defendant could demonstrate that it could not have made the product which injured the plaintiff. Subsequently, in *Bichler* v. *Eli Lilly & Co.* (1982), the New York Court of Appeals affirmed a jury verdict against a manufacturer of DES which was based upon the plaintiff's theory that Lilly, in concert with other DES manufacturers, had wrong-

fully marketed this drug without proper testing. Under this "concert of action" theory, the court in Bichler found the defendant liable for the plaintiff's injuries even though the plaintiff had failed to prove that Lilly—the only defendant named in the suit—was the manufacturer of the DES that the plaintiff's mother had ingested".[1]

In both *Sindell* and *Bichler,* the rationale underlying the courts' decisions was the same. In both cases, the court was confronted with an innocent victim unable to prove which manufacturer harmed her because of the long latency of the injury coupled with the similarity among the products of the different manufacturers. Faced with a choice between not compensating the victim and holding liable a company which may have caused the harm, each court chose a theory which would permit compensation of the victim.

Other judicial decisions have weakened defenses based upon the state of the art and technological or economic feasibility. In *Beshada* v. *Johns-Mansville Products Corp.* (1982), a manufacturer of asbestos in the 1930's was found to have an obligation to warn of the dangers associated with asbestos products. The manufacturer was not permitted to prove that at the time in question it was not possible to determine the possible harmful affects of asbestos. Prior to this decision, under the state of the art defense, even in strictly liability cases, no manufacturers would be held liable for harm caused by conduct or products that could not have been anticipated under state of the art knowledge. This novel decision is a particularly significant finding for chemical product manufacturers because they may be held liable even in instances in which the harmful potential of the product was not discoverable at the time.

Rulings of this type dispense with a fundamental element of the tort system—proof that the defendant ws responsible for the plaintiff's harm. Such rulings disrupt the reasonable expectations of both manufacturers and insurers concerning the limits of their liability.

Judicial misinterpretations of insurance policies designed to respond to limited types of pollutions exposures have created additional concerns among insurers. Recent court decisions have expanded insurance coverage for cleanup of waste treatment, storage and disposal facilities beyond that which the liability policies were designed to provide. Insurers have lost confidence in the words and phrases of art which have been placed in pollution insurance contracts in order to exclude coverage which may be provided in other insurance policies or which may be properly excluded due to the unpredictable or potentially catastrophic nature of the exposures.

The Comprehensive General Liability (CGL) insurance policy is the instrument used to provide the vast majority of insurance protection for commercial entities from liability for bodily injury and property damage. The CGL insurance policy is a contract between the insurer and the insured in which the parties define both the risks covered by the insurance and those excluded from coverages. The premium charged by the insurance company relates directly to the frequency and severity of the risk that the company intends to insures. Courts have elected to misinterpret the insurane policy contract language in order to maximize insurance coverage for damages related to hazardous waste.

Some decisions have gone so far as to rewrite policy terms and create coverage which insurers never intended to provide and for which no premium was even collected. Specifically, we perceive a trend in court decisions that interpret our standard CGL policy to broaden the scope of intended coverage as follows:

"Narrowing the intent of the owned property exclusion to find liability for damange to an insured's property.[2]

"Overriding the scope of the pollution exclusion so that, for example, well contamination caused by seepage at a hazardous waste site that occurred over a 12 year period was found to be covered despite the policy requirement that coverage be afforded for only "sudden and accidental" pollution.[3]

"Coverting the CGL's policy dollar limit per occurrence into a per claim dollar limit.[4]

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[1] Villanova Law Review, Volume, 28, No. 6, September, 1983 p. 1102-1104.

[2] *See* for example, *Riehl* v. *Travelers Insurance Co.*, — F. Suppl. —, Civil Action No. 83-0085 (W.D. Pa., August 13, 1984).

[3] *See,* for example, *Jackson Township Municipal Utilities Authority* v. *Hartford Accident and Indemnity Company,* 186 N.J. Super. 156, 451 A. 2D 990 (1982). *Waste Management of Carolinas, Inc.* v. *Peerless Insurance Company,* 323 S.E. 2D 726 (Court of Appeals of North Carolina, December 28, 1984).

[4] *See Township of Jackson* v. *American Home et. al.,* Docket No. L-29236-8 (Law Div., August 31, 1984).

"Setting aside the definitions of property damage and bodily injury so as to award speculative damages for the possibility of future harm".[5]

The possibility of similar misiterpretations leading to expansion of coverage in the commercial auto policy exists due to the inclusion of the category of damages for "environmental restoration" in the Motor Carrier Act. Many commercial auto insurers have reacted by excluding environmental restoration from their commercial auto policies.

Concurrent with judicial misinterpretations of insurance contracts, rapidly expanding liability concepts, and the recent drain on insurance industry surplus, the Congress has created a series of expanded responsibilities for insurers and their policyholders by mandating evidence of financial responsibility in a series of recently enacted federal legislation. The Motor Carrier Act (1980) and the Bus Regulatory Reform Act (1982) have mandated large minimum insurance requirements for buses and trucks. In the case of a motor carrier transporting extra-hazardous substances or a bus with a seating capacity in excess of fifteen, the minimum requirement for insurance is $5 million per vehicle. Although the Resource Conservation Recovery Act was enacted in 1976, the final rule associated with the financial responsibility requirements for waste, treatment and storage facilities was promulgated in 1980. Those financial responsibility requirements have been phased-in over the last 5 years. An additional waive of financial responsibility requirements can be anticipated in association with the Comprehensive Environmental Response, Compensation, and Liability Act of 1980. All of these requirements for evidence of financial responsibility have coincided with the insurance industry's underwriting losses beginning in 1979.

INSURER OPERATING RESULTS

In order to put the present liability insurance problems in perspective, it is necessary to understand the overall financial condition of the insurance industry today. Since 1980, losses and expenses have exceeded premiums primarily because prices failed to keep pace with loss costs. As a result, an unbroken string of underwriting losses began in 1979 and grew at an average annual rate of $3 billion through 1983. An even more dramatic increase took place in 1984 when underwriting losses jumped $8 billion, reaching $21.3 billion. Losses from underwriting for the six years 1979 through 1984 totalled $55 billion. With investment income falling far behind underwriting losses, the industry's per-tax operating income—the combination of investment income and underwriting results—plunged to a negative $3.8 billion in 1984.

The commercial liability lines experience has been particularly negative. Four key commercial lines—general liability, commercial multi-peril, workers; compensation and commercial automobile—have suffered enormous underwriting losses. General liability leads all lines of insurance with the highest combined ratio of 152.

As a business, the industry cannot afford to indefinitely price its product at less than cost. The cost of the civil justice system is rising, therefore the cost to service the nation's liability systems must also rise.

VOLUNTARY SOLUTIONS

The American Insurance Association has thus far categorized pollution liability and asbestos abatement contractors' liability as falling into the unmanageable or uninsurable category. In addition, there are a number of availability problems in lines that are badly damaged by the liability system, but there is still a potential that insurers can provide coverage.[6] In these areas AIA will work actively with its companies, other trade associations and state insurance commissioners to explore voluntary Market Assistance Programs or other market solutions to the problem. A Market Assistance Program (MAP) establishes a central administrative point where a buyer who is experiencing difficulty in purchasing insurance may come in order to be referred to one or more participating insurers who employ their established underwriting criteria and rating plans. A MAP can also serve to gather information about real or perceived availability problems and be a focal point around which the insurance department buyers' groups, agents and brokers may discuss availability problems in a constructive manner.

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[5] *Ayers et al.* v. *Township of Jackson*, 189 N.J. Super. 561 (Ocean County, April 5, 1983).

[6] Day Care Centers, Liquor Liability, Directors and Officers, Physicians Malpractice Insurance, Nurse Midwives, Commercial Auto Insurance (Long Haul Trucking Companies and Bus Companies), Rural Homeowners Insurance.

It should be emphasized that merely shifting the burden from one insurance mechanism to another does not address the key problem associated with availability/affordability of liability insurance. Artificial, involuntary insurance mechanisms such as Joint Underwriting Associations mask the underlying problem. The answer to this dilemma has been and remains tort reform. There is a tendency among some regulators and legislators to adopt the expeditious approach of forcing insurers to write insurance coverage, either on an assigned risk or a pooled basis. This solves the immediate availability problem at no apparent cost to the public treasury and with no need to address the difficult task of reforming the tort liability system.

Structuring alternative insurance mechanisms addresses a symptom rather than the cause of the current casualty insurance availability and affordability situation. Although alternative insurance mechanisms may be necessary in order to respond to federal and state financial responsibility requirements, a thorough review of common law decisions and state and federal statutory liability concepts is essential if casualty insurance is to be both affordable and available in the future.

[The following information was subsequently received for the record:]

Question. How are rates set?

Answer. Rates are set generally by line of business risk classification for each state. In some cases, rates are set for rating territories within a state. Rates are based on the historical loss experience for each risk classification in each state or rating territory.[1]

Risk classifications in liability insurance usually correspond to, but are not exactly the same as, two or three-digit Standard Industrial Classification (SIC) codes. For example, public schools and streets, roads, and highways are classified by the Insurance Services Office (ISO) as codes 93221 and 93151, respectively; the two-digit SIC code for local government is 93.

Rating territories are often single or groups of counties or towns that are either adjacent or have similar demographic characteristics. They are generally not used as much in commercial general liability insurance as in other lines, principally because of the need for actuarial data bases to be large enough to produce credible (statistically reliable) ratemaking information. Also, there may not be significant differences in commercial liability rating characteristics from one part of a state to another.

Rates are calculated from historical loss (claims) experience, with factors included for underwriting and loss adjustment expenses. Historical loss costs are adjusted for trends, either downward or upward, depending on whether loss costs for the coming policy period are expected to go down or up from the prior period. Individual insureds may be rated on either an experience or retrospective basis that takes into account either their claims activity during past periods or their claims activity during the new policy term.

Question. What is the relationship between tort laws and insurance premiums in a state? What percentage of claim payments are the result of court awards? What is the relationship between court awards and premiums in particular lines?

Answer. Available aggregate data on loss experience do not indicate whether claim payments resulted from court awards of from settlements either before or during trial. However, a number of industry studies are underway that will be collecting data on the role of actual or potential litigation in the settlement of product liability and auto and homeowners cases. Results of these studies should be available around the middle of this year.

In the meantime, it is clear that adverse laws and judicial decisions are discouraging insurers from providing coverage in certain lines of business.

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[1] A report prepared by AIA on Product Liability Underwriting and Ratemaking is enclosed.

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Question. Is the Jackson Township case typical of cases throughout the country? Have similar cases been dismissed or decided in favor of the insurer?

Answer. There is no discernible trend relative to judicial misinterpretations of the comprehensive general liability insurance policy in order to find coverage to respond to waste treatment, storage and disposal facilities. It should be understood that the cases cited below clearly reflect a dichotomy on the part of the American judiciary. Some decisions fnd no ambiguity in the crucial insurance language. Others seem bent on the most expansive interpretations of law and contractual language. If those most expansive decisions are followed and upheld, the worst concerns of insurers will be borne out.

There are two lines of decisions interpreting the occurrence and pollution exclusion language cited above. Those which find coverage notwithstanding the exclusions are listed first. Those which deny coverage follow. Crucial cases are listed here. (Only the Molten decision in Alabama is from a state's highest court):

In the case of *Jackson Township Municipal Utilities Authority* v. *Harford Accident and Indemnity Company,* 451 A.2d 990, 186 N.J. Super. 156, (this 1982 Superior Court decision has been affirmed by the New Jersey Appellate Court and is scheduled for review by the state's Supreme Court) Justice Havey rendered the decision which epitomizes those cases in which coverage has been found notwithstanding the pollution liability exclusion. The court said:

> When viewed in light of the case law cited, the clause can be interpreted as simply a restatement of the definition of "occurrence"—that is, that the policy will cover claims where the injury was "neither expected nor intended." It is a reaffirmation of the principle that coverage will not be provided for intended results of intentional acts but will be provided for the unintended results of an intentional act.

The allegations against Jackson Township were that it had acquired a landfill in 1972 and was negligent in the selection of the site and the design and maintenance of that landfill. This resulted in seepage of pollutants into the Cohansy aquifer which apparently occurred over a period of twelve years, damaging 97 wells. The trial resulted in a verdict in favor of the well owner in an amount just under $16 million. That judgment included sums awarded for the disruption of quality of life due to the need for substitute water supplies, and sums to cover future medical mnitoring to determine whether injuries had been sustained by the claimant. The portion of the award associated with "risk of future harm" was subsequently stricken in an appellate court review. In disposing of the language contained in the insurance contract which rendered coverage only if events were "sudden" and "accidental," the court said, ". . . although the permeation of pollution into the groundwater may have been gradual rather than sudden, the behavior of the pollutants as they seeped into the aquifer is irrelevant if the permeation was unexpected."

Allstate Insurance Company v. *Klock Oil Company,* 73 A.D. 2d 486 (Appellate Division 1980) involved interpretation of the same language of the pollution exclusion in an incident where a gasoline storage tank installed and maintained by the insured leaked. The tank was installed in 1971 and in 1974 an adjoining landowner complained of a contaminating leak. The court said, "If there was no intent to cause harm then any injury resulting from ordinary negligence is considered to be accidental," and in dealing with the question of whether the event was sudden, the court said,

> Also the word "sudden" as used in liability insurance need not be limited to an instantaneous happening (McGroarty v. Great American Ins. Co., 43 A.D. 2d 368, 351 N.Y.S. 2d 428, affd. 36 N.Y. 2d 358, 368 N.Y.S. 2d 485, 329 N.W. 2d 172 Appellate Division). The term "sudden and accidental" must be

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[6] *Ayers et. al.* v. *Township of Jackson,* 189 N.J. Super. 561 (Ocean County, April 5, 1983).

> construed in its relevant context. The relevant context to be considered is the fact that it is a term employed by an insurer in the contract and should be given the construction most favorable to the insured. Thus, regardless of the initial intent or lack thereof as it relates to causation, or the period of time involved, if the resulting damage could be viewed as unintended by the factfinder, the total situation could be found to constitute an accident (McGroarty v. Great American Ins. Co., 36 N.Y. 2d 358, 364, 368 N.Y.S. 2d 485, 489) and therefore within the coverage afforded by Allstate in the comprehensive general liability insurance policy issued to Klock.

In *CPS Chemical Company, Inc.* v. *The Continental Insurance Company and United States Fidelity and Guaranty Company,* Superior Court of New Jersey, Law Division, Essex County, Docket No. L 039547-81, decided August 8, 1984, the court stated that the insurer's reliance upon the pollution exclusion had a "superficial attraction." The court justified holding against the insurance company with the following conclusion:

> It is well recognized that ambiguities in insurance policies are resolved against the carriers which drafted them. Here, the words "sudden" and "accidental" have been interpreted by recognized dictionary definitions to include unexpected and unintended events. It may well be that the drafters of this clause believed that "sudden and accidental" connoted a sense of a dramatic catastrophe, limited in duration and immediate in its consequences, but it cannot fairly be said that this was unambiguously expressed.

In *Niagara County* v. *Utica Mutual Insurance Company,* 80 A.D.2d 415, (Appellate Division 1981) it was charged that while the defendant county negligently allowed dumping to occur, it had never actually dumped itself. The court decided that coverage would apply notwithstanding the pollution exclusion which was required by statute in New York, "The conclusion thus becomes compelling that the pollution exclusion clause, mandated by statute, was intended to apply only to actual polluters." The court never dealth with the requirement that the pollution be sudden.

In *United Pacific Insurance Company* v. *Van's Westlake Union, Inc.,* 664 P. 2d 1262 (Court of Appeals of Washington 1983), the court concluded, "The insured in the case before us was not an active polluter. The gasoline leaking from a hole in the underground line was not expected or intended, nor was the resulting damage. Thus, the pollution exclusion clause did not exclude coverage for the third party claims and suits against the unsured. To hold otherwise would permit the ambiguous pollution exclusion clause to unfairly devour much of the policy and relieve the insurer from liability clearly within the spirit and intendment of the policy."

In *Molton, Allen and Williams, Inc.* v. *St. Paul Fire and Marine Insurance Co.,* Ala., 347 So. 2d 95 (Supreme Court 1977), in which a real estate contractor land developer allowed mud, sand and dirt to cause property damage on adjoining property, the court held that the pollution exclusion did not apply because it was intended only to cover industrial pollutants. The court noted that the specifically listed pollutants didn't include mud or sand and so refused to read them into the generic portion of the clause. The court went further and said, "The question is whether the 'pollution exclusion' clause applies. We hold that it does not. By so holding, however, we should not be understood as holding that sand or mud could never be an irritant, contaminant or pollutant, or that the insurance company could not write an exclusion clause which would cover the activity here involved. We hold only that this policy clause, under the stipulated facts of this case, does not eliminate coverage."

A recently reported case of *Buckeye Union Ins. Co.* v. *Liberty Solvents and Chemicals Co.,* Ohio Court of Appeals #11598, 7/11/84, involved a CERCLA suit for clean-up of the Chem Dyne dump in Ohio. Liberty Solvents was named as one of the generators of hazardous waste at that site. the court held that while the dumping was intended, the resulting damage was neither expected nor intended from the standpoint of Liberty Solvents; therefore, the allegations did allege an occurrence under the policy for which carrier must defend.

A recent decision on the pollution exclusion appeared in *Waste Management of Carolinas, Inc.* v. *Peerless Insurance Company,* 323 S.E. 2d 726 (Court of Appeals of North Carolina, December 28, 1984). This case involved an insurance coverage question arising from litigation by the United States under Section 7003 of the Resource Conservation and Recovery Act. The United States had requested injunctive relief and reimbursement of costs arising out of groundwater contamination allegedly caused by the Flemington Landfill. The landfill owners in turn sought indemnity and contribution from the insured on the ground that it was careless and negligent

in not exercising proper care to prevent the deposit of hazardous waste while it was delivering solid waste.

These deposits had occurred from 1973 to 1979. The court in construing the pollution exclusion found that the meaning of "accident" should be determined by reference to the definition of "occurrence" and that in this instance the damages which occurred were neither intended nor expected from the standpoint of the insured. The court also said:

> The exclusion hinges on the words "sudden and accidental." The policies do not define these words, and some courts have observed that this may be enough to create ambiguity in the exclusion.

The court went further and found:

> We find that the word "sudden" is reasonably susceptible of differing constructions and we construe it not to mean just "instantaneous", but also "unforeseen" or "unexpected". This construction renders the pollution exclusion consistent with the definition of "occurrence" in the coverage provisions.

Not all courts have found that the pollution exclusion is ambiguous or subject to any of the interpretations cited above.

In *Great Lakes Container Corporation* v. *National Union Fire Insurance Company of Pittsburgh*, United States Court of Appeals for the First Circuit #83-1607 on January 3, 1984, the court said:

> We agree with the district court that when the policy is read against the complaint there is no ambiguity and exclusion (f) applies. The government has alleged the Great Lakes is liable because pollution and contamination of the soil, surface and subsurface waters has taken place as a concomitant of its regular business activity. Property damage resulting from such activity falls squarely within the language of exclusion (f). There is no "occurrence" within the meaning of the policy alleged, nor any allegation of a sudden and accidental discharge.

In this case, the defendants operated a barrel reconditioning business on their site where up to 60,000 drums were stored pending reconditioning. In the course of reconditioning, the barrels are emptied of chemicals and washed by various industrial processes. The wastes from the drums, it is alleged, were discharged upon the ground of the defendant, had contaminated the soil, and migrated toward the groundwater. It was also alleged that on or about March 10, 1980, there was a discharge of pollutants from the plant into a stream.

In *American States Insurance Company* v. *Maryland Casualty Co.*, 587 F. Supp. 1549, U.S.D.C., E.D., Mich. (1984), the court denied insurance coverage in four lawsuits arising out of the dumping of toxic waste materials. It was alleged toxic wastes were dumped continuously from 1966 causing water source contamination. In the underlying action plaintiffs claimed harm to themselves and to the use of their property. In denying coverage, the court said, "The allegations in the four complaints suggest that the release of toxic materials was continuous and not in any way sudden or accidental, and therefore do not even arguably state an "occurrence" which would require the insurers to defend and/or indemnify National Drum."

In the case of *Barmet of Indiana, Inc.* v. *Security Insurance Group*, Ind. App. 425 N.E. 2d 201, (Court of Appeals 1981) it was held that the pollution exclusion was not ambiguous and excluded coverage. The court said,

> Although Barmet could not predict exactly when its pollution control system would malfunction, it was shown that Barmet's system malfunctioned on a regular and frequent basis, ranging from daily to occasional. Barmet was aware of this problem and had received numerous complaints. With this factual background, we cannot accept Barmet's contention that the discharge of the emissions was sudden and accidental within the meaning of the policy. Although Barmet may not have intended for the emissions to obstruct the visibility and thus, perhaps, contribute to the accident, this problem was certainly foreseeable because Barmet had received numerous complaints regarding their emissions. Barmet may have been unable to predict the exact time when the emissions would be discharged, but they certainly knew the emissions would continue as a part of their business operations. We remain unpersuaded that the accident was unforeseeable and unpredictable.

Two contrasting cases are *Pepper Industries, Inc.* v. *Home Insurance Company*, 134 Cal. Rptr. 904 Court of Appeals (1977)) and *City of Milwaukee* v. *Allied Smelting Corporation*, 344 N.W.2d 523 (Court of Appeals 1983). In *Pepper Industries*, the court determined that ambiguities must be resolved against the insurer and said, ". . . if semantically possible, the policy must be construed so as to achieve its manifest object of indemnifying the insured against losses to which the policy relates." The court there held that the City's sewer system was damaged by an explosion of gasoline which had been discharged into that system by the defendant, and was not subject to the pollution exclusion because the exclusion did not say coverage would be denied when there was an explosion and fire.

In the *City of Milwaukee* case, coverage was denied for property damage to the City's sewer system caused by the discharge of sulphuric acid into the City's concrete sewer. The court upheld the pollution exclusion clause saying, "In construing an insurance contract, it is fundamental that no insurance contract should be rewritten so as to bind any insurer to a risk which it did not contemplate and for which it was not paid, unless the terms are ambiguous or obscure." The court further said,

> In spite of the cities' contention that any runoffs that may have occurred were sudden and accidental, the record and common sense stand in firm refutation of the validity of such a conclusion. The uncontroverted expert testimony establishes that in order for the damage to have been created by the acid levels which existed, the sewers had to have been subject to the acid for a period of from two to ten years. When this is considered together with Allied's normal twenty-four hour workday, it provides more than adequate grounds to reject the cities' contention. Because we conclude that the exclusionary clause is applicable to this case, we hold that Contintental's policy of insurance does not provide Allied coverage for this situation.

The cases cited above are by no means exhaustive. Other important cases interpreting the pollution exclusion include: *Travelers Indemnity company* v. *Richard Dingwell*, Me. 414 A.2d 220 and *Lansco* v. *Environmental Protection Dept.*, 350 A.2d 520 (New Jersey 1975). In addition, the Honorable James M. Havey, author of the Jackson Township decision, in the summer of 1983 edition of *New Jersey Lawyer* discussed these issues. He puts forth interesting arguments which may be used in favor of extending coverage. He concludes the article with the statement that, "The novelty of the issues presented affords litigants an opportunity to be resourceful and imaginative in presenting solutions."

Insurers are by no means limited in their concerns with those issues which arise simply from the pollution exclusion. Some cases have held insurers liable for onsite investigation and testing liabilities, *United States Aviex Co.* v. *Travelers Insurance Co.*, 336 N.W.2d 838 (Mich. App. 1983). That case held that an insurer could be liable for sums expended by an insured in order to comply with equitable and injunctive orders. This court also held that the $116,000 in investigative cost was in addition to the $500,000 indemnity limit in the Travelers policy.

See also *Ralph R. Riehl, Jr.* v. *Travelers Insurance Co.*, U.S.D.C., W.D. Pa. #83-0085, filed August 7, 1984, in which the court held that the surface and subsurface water on plaintiff's land was not property owned by insured and therefore not subject to an exclusion for damages on property owned by the insured. Therefore the defendant insurer was obligated to defend the plaintiff and to undertake additional measures which might prevent additional harm to others than the plaintiff relative to removal and containment of hazardous wastes at the plaintiff's location.

It is worth noting in this troublesome area that the duty of an insurer to provide a legal defense is generally broader than its duty to indemnify and often exists until it is clear that no facts which could lead to indemnification can be reasonably expected to be proved. (See *Travelers Indemnity Company* v. *Richard Dingwell*, supra. These expenses are not usually included in the policy's dollar limits.)

Many observers expect that legal expenses in the environmental area will be very high, similar to the extraordinary expenses involved in asbestos litigation. (See the Rand Institute for Civil Justice studies which show much more money going to attorneys than claimants in asbestos litigation.) It is too early to have the figures on environmental litigation, but it appears that litigation on environmental issues is very expensive and time-consuming.

Recently, four United States Circuit Courts of Appeal developed three different theories for insurance coverage in asbestos causes. In general the courts used coverage-maximizing logic. For purposes of this discussion, these cases are cited only to show that the U.S. Supreme Court has allowed states to craft different interpretations of exactly the same insurance policy language. If the court follows the same

approach on the pollution exclusionary language insurers would be bound by some state court determinations even where other courts have found to the contrary that coverage does not exist. See *INA* v. *Forty-Eight Insulations*, 633 F.2d 1212 (6 Cir. 1980) cert. denied 102 S. Ct. 686, 1981 *Porter* v. *American Optical Corp.*, 641 F.2d 1128 (5 Cir. 1980); *Keene Corp.* v. *INA*, 677 F.2d 1034 (D.C. Cir. 1981) cert. denied 102 S. Ct. 1644 (1982); and *Eagle-Picher* v. *Liberty Mutual*, 682 F.2d 12 (1st Cir. 1982) cert. denied (March 7, 1983).

Question. To what extent is the insurance industry responsible for its current financial condition?

Answer. It should be emphasized that the "insurance industry" is not monolithic. Even the largest companies have a small portion of the total market share in any single line of insurance. Individual insurers engaged in intense competition in the early 1980's in pursuit of the premium dollar in order to invest. Insurers were able to reduce the price of their product by balancing underwriting losses with investment income until 1984. Lower prices inure to the benefit of the policyholder.

Extraordinary losses experienced by insurers, particularly in commercial casualty lines, have forced insurers to raise premiums drastically. These premium increases have clashed with the expectations of policyholders, causing hardship among some policyholder groups who rely on various lines of commercial liability coverage.

It is extremely difficult to gage the impact of insurer responsibility for its current financial condition relative to other major factors such as statutory and common law modifications in the tort system, judicial misinterpretations of insurance contracts, mandated minimum levels of insurance in federal [7] and state laws and extraordinary awards associated with multiple causation, long-latency diseases.[8] It is clear that each of these factors plays both a singular and synergestic role in the industry's current financial condition.

The extent of exposure for liability insurance coverage has changed dramatically in the past decade. The relationship between low level exposures to useful, but sometimes harmful substances, and injuries to human beings is not well understood today and is still to a large extent speculative. Tort law a few years ago did not concern itself with speculative possibilities of harm. Doctrines of joint and several, enterprise liability had not been formulated. It was not until 1974 that the deluge of asbestos-related claims began.

The concept of accident as a single scenario involving one person causing another's harm has changed. Increasingly, recent tort law has applied traditional concepts of individual risk-placing causation and harm into the modern commercial context. The result is that certain communities, types of persons throughout the nation, or classes exposed to risk of harm through commercial enterprises have sought to redress their harm through the liability system and have sought to hold entire industries liable for the creation of public risks. New types of suits different from traditional cases in that:

Injuries are medically complex, and have multiple causes often resulting in the introduction of presumptions into the legal system,

Injuries have been attributed to exposure over a lengthy period of time,

Injuries have been applied to groups or classes of claimants,

Defendants are often a small number of entities or businesses or whole industries involved in certain types of behaviors.

Question. For commercial auto, commercial multi-peril, and commercial general liability, what percentage of claims paid in 1984 resulted from judicial decisions and what percentage represented uncontested settlements? By how much have premiums in those lines increased since 1984?

Answer. As mentioned earlier, available industry data do not split claim payments between awards and settlements.

Estimated increases in net written premiums for these lines from 1984 to 1985 were as follows:

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[7] Bus Regulatory Reform Act, Motor Carrier Act, Superfund, and the Resource Conservation and Recovery Act.

[8] *Ayers* v. *Jackson Township* (N.J., 1983)—$15.6 million settlement for alleged waste site injuries.

Dietz v. *Gray Brothers* (Pa., 1984)—$750,000 judgment for alleged waste site injuries.

In Re Agent Orange (N.Y., 1984)—$180 million settlement for alleged defoliant injuries.

U.S. v. Olin (Ala., 1983)—$24 million settlement for alleged DDT disposal site injuries.

Piatt v. *Independent Petrochemical* (Mo., 1983)—$2.6 million judgment for alleged dioxin injuries.

LaPoint v. *Hooker Chemical* (N.Y., 1984)—$20 million settlement for alleged Love Canal waste site injuries.

	Percent
Commercial auto	33.9
Commercial multi-peril	43.0
Other liability	71.8

While these increases are dramatic, it should be remembered that these lines were still highly unprofitable during 1985 despite their amounts of premium growth. The corresponding ratios of loss costs and expenses to premiums for these lines in 1985 are shown below:

	Percent
Commercial auto	120.2
Commercial multi-peril	124.2
Other liability	144.5

Ratios of this magnitude would not produce an adequate return even with investment income included.

Question. What percentage of all commercial property/casualty claims in 1984 resulted from judicial decisions?

Answer. Again, data are not available to answer this question. Payments for both awards and settlements are included in insurer "losses". The ratemaking process does not demand that these losses be broken down to reflect payments for awards and settlements.

Question. Is there a causal relationship between a policyholder's claims record and premium increases, nonrenewals, and midterm cancellations?

Answer. Rates are based on the loss experience for a class of business within a state or rating territory. In some cases, an insured may be experience rated or retrospective rated. In experience rating an insured's past experience is capared to the average experience for his class and region and his premium is adjusted downward or upward depending on whether his past experience is better or worse than average. In restrospective rating, a similar adjustment is made at the end of the policy period based on the insured's actual loss experience compared to the expected experience used in the initial rate calculation.

Of course, for an insured who is not rated individually, premium rates could go up even though the insured did not have any past claims. That would occur if the experience for the class the insured belongs to was sufficiently adverse to justify a rate increase. The new rate would apply to all insureds in the class because it would not be possible to determine in advance which particular insureds would have claims and which would not. An insured's lack of claim in the past is no guarantee against his having any claims in the future.

Sometimes it becomes necessary for an insurer to cancel or nonrenew a policy because the insured's loss experience turns out to be worse than expected when the policy was issued. This could occur because either the insured misrepresented himself to the insurer, the degree of hazard increased significantly during the policy term, or reinsurance was terminated in response to the insured's adverse experience.

As was the case with rate increases, an insured may find his coverage cancelled or not renewed even if his own claims experience was favorable. Insurer decisions to curtail underwriting a class of business are based on unfavorable loss experience for the entire class or on adverse trends affecting all business within the class. Insurers will be forced to stop underwriting a class of business if these factors indicate either that the class is uninsurable or that the class can be insured only at a premium rate that the market would consider unaffordable.

An insurer's loss of surplus and reduction in capacity may create problems with its premium to surplus ratio, thereby forcing an insurer to reduce its premium volume. In some instances insurers may cease to provide coverage in order to eliminate exposure in involuntary insurance mechanisms. For example, with respect to commercial auto insurance, each state has an assigned risk pool in which insurers must participate. If a motor carrier can produce a valid drivers license and can pay the premium, coverage must be provided by commercial auto insurers. If a motor carrier transports extra-hazardous substances, the minimum level of insurance which must be provided is $5 million. Commercial auto insurers with impaired capacity may seriously consider leaving the market in order to avoid participation is the assigned risk pool.

Question. Is there a relationship between jury awards in one part of the country and premiums in another?

Answer. In general, other than products liability, rates are established in geographical areas or zones which may or may not conform with state boundaries. In-

surer losses experienced in one part of the country are not recuperated by increasing premiums in another part of the country.

However, common law decisions which result in unexpected awards such as *Beshada, Sindell,* and *Jackson Township* must be considered in the underwriting process. Extraordinary changes in tort law which modify causal relationship, burden of proof, or distort the contractual relationship between insurer and policyholder must be acknowledged by insurers. A common law decision in California may be used as precedent in the courtroom throughout the United States. Common law developments are not contained by State boundaries. Insurers must factor into their ratemaking and underwriting procedures the likelihood that dramatic changes in the tort law in one state may result in similar modifications in other states.

Question. Do actions prohibiting midterm cancellations or midterm premium increases in one state affect premiums written in another state? Do insurers try to offset the effects of rate ceilings in one state by raising rates elsewhere?

Answer. Regulatory pressures prevent insurers from making up for inadequate rates in one state by raising rates in another state. Premium rates are required to cover only future loss costs and expenses for the rating class and rating territory in question and cannot include allowances for losses in other periods, classes, or geographic areas.

Question. How long will dramatic rate increases, abandonment of particular insurance lines, and general availability problems continue?

Answer. The property/casualty insurance market is in a current state of disequilibrium. Equilibrium requires a balance between premiums on the one hand and losses and expenses on the other. One estimate by Daniel J. McNamara, President of ISO, is that any recovery ". . . must extend beyond 1988 to repair the industry's severely damaged financial structure.

Traditionally, cycles of underwriting losses and underwriting profitability occur every three years. However, the current cycle of underwriting losses has continued for six years. Underwriting losses during that period approximate $55 billion. Although investment income has been rising gradually over the last several years, it could not offset underwriting losses in 1984 and 1985. The industry's pre-tax operating income—the combination of investment income and underwriting results—reached a negative $3.8 billion in 1984 and a negative $3.5 billion in the first nine months of 1985. This figure, pre-tax operating income, is the primary component of insurer income and represents the pre-tax profits from insurance operations. It is this component of income which reflects the long-term viability of the industry.

Insurers have made very effort to restore lost surplus and increase their net worth through external means such as insurance stock offerings and liquidating assets. However, the true barometer of insurance industry well-being is a return to underwriting profitability or, at the very least, a reduction in underwriting losses so that investment income again balances or exceeds underwriting losses. Premium increases and/or modifications to the tort system are necessary in order to achieve this objective.

Question. Will the various tort reforms advocated by the insurance industry translate into lower premiums?

Answer. Tort reform should lead to premiums being less than what they would be otherwise in the absence of significant tort reform measures. This could occur through direct reductions in loss costs (on which premiums are based), less uncertainty about the sizes of future awards, and increased market capacity on the part of current writers and new entrants.

Question. What specific actions should be taken to correct the current problems in various lines of insurance?

Answer. The American Insurance Association has thus far categorized pollution liability and asbestos abatement contractors' liability as falling into the unmanageable or uninsurable category. In addition, there are a number of availability problems in lines that are affected by the tort liability system, but there is still a potential that insurers can provide coverage.[9] In these areas AIA will work actively with its companies, other trade associations and state insurance commissioners to explore voluntary Market Assistance Programs or other market solutions to the problem. A Market Assistance Program (MAP) establishes a central administrative point where a buyer who is experiencing difficulty in purchasing insurance may come in order to be referred to one or more participating insurers who employ their established underwriting criteria and rating plans. A MAP can also serve to gather information

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[9] Day Care Centers, Liquor Liability, Directors and Officers, Physicians Malpractice Insurance, Nurse Midwives, Commercial Auto Insurance (Long Haul Trucking Companies and Bus Companies), Rural Homeowners Insurance.

about real or perceived availability problems and be a focal point around which the insurance department, buyers' groups, agents and brokers may discuss availability problems in a constructive manner.

It should be emphasized that merely shifting the burden from one insurance mechanism to another does not address the key problem associated with availability/affordability of liability insurance. Artificial, involuntary insurance mechanisms such as Joint Underwriting Associations mask the underlying problem. The answer to this dilemma has been and remains tort reform. There is a tendency among some regulators and legislators to adopt the expeditious approach of forcing insurers to write insurance coverage, either on an assigned risk or a pooled basis. This solves the immediate availability problem at no apparent cost to the public treasury and with no need to address the difficult task of reforming the tort liability system.

Structuring alternative insurance mechanisms addresses a symptom rather than the cause of the current casualty insurance availability and affordability situation. Although alternative insurance mechanisms may be necessary in order to respond to federal and state financial responsibility requirements which make the acquisition of insurance a prerequisite for doing business, a thorough review of common law decisions and state and federal statutory liability concepts is essential if casualty insurance is to be both affordable and available in the future.

Senator PRESSLER. Thank you very much.

Ms. Mindy Pollack, assistant general counsel, Reinsurance Association of America.

Ms. POLLACK. Thank you very much.

Our association represents U.S. professional reinsurance companies. Our members are either domiciled here in the United States or they are U.S. branches of foreign reinsurance companies. However, they are all subject to the regulatory jurisdiction of the United States.

Before addressing the effect of the availability and affordability of reinsurance, I would just take the opportunity to define reinsurance and discuss its importance to the insurance industry. Reinsurance is an insurance transaction whereby a primary insurance company will pay a premium and the reinsurance company will indemnify that primary insurance company for losses it has sustained under its own insurance policies.

It is a contract of indemnification. The reinsurance company does not have any contractual relationship with the policyholder. In this sense, it is truly the insurance of insurance companies.

The reinsurance industry is a very worldwide insurance industry. As you are probably aware, the U.S. reinsurance industry probably represents approximately 75 percent of the initial reinsurance premium; 25 percent of the total reinsurance premium goes abroad.

However, the international marketplace is very important in what we call the retrocessional market. Reinsurance companies here, our members, also need to spread their risks abroad and they use this foreign capacity through retrocessional agreements. In this sense, the foreign market is extremely important to the U.S. insurance industry.

All the problems you have heard discussed today—the financial conditions and even the recommendations for tort reform—all apply to the reinsurance industry as well. If a risk can be insured, it can be reinsured. Similarly, if there are problems with insuring it, there are going to be problems with reinsuring it.

The problem that our reinsurance industry is finding itself in is that the recent catastrophic results in the insurance industry have hit reinsurers a bit harder, and there are many reasons why the reinsurance industry has been hit harder. Most of them have to do with the nature of the business.

Reinsurers happen to be concentrated in the casualty lines of the business, which have experienced the worst results in recent years. It is also a very competitive business and in the past few years has seen a tremendous amount of competition, with premiums dropping to fairly low levels.

When losses started coming in the casualty business, reinsurers found that premiums were not sufficient to pay for these losses. Consequently, the reinsurance industry has reported combined ratios in 1984 which were higher than any other year prior to this. In addition, they found that their policyholder surplus, which is the measure of strength for an insurance company, was depleted by 7 percent.

Typically, the reinsurance industry's results follow those of the primary insurance industry very closely. What we found, for all the factors I just noted—the difference in the type of the business etc.—the reinsurance industry's results have deteriorated far worse than those of the primary insurance companies.

There has been a divergence of combined ratios for the reinsurance industry. Our loss ratios were 10 points higher than that of the primary insurance industry for the past year. We have found as a result definitely a decreased capacity in the reinsurance industry.

Our organization surveys the U.S. reinsurance market. We reported 18 fewer organizations in our survey than we did the year before. The reason for this is many reinsurers have gone insolvent, and many more have cut back entire lines of business. In addition, many new entrants to the reinsurance industry in the past few years have left and gone on and moved their capital to other areas which are more profitable.

So all in all, there has been a decrease in capacity as companies are finding that they do not have the financial resources to stay in the business. Without a doubt, we are now seeing premium increases in the reinsurance market. The question is whether that will be sufficient to attract new capital back into the reinsurance industry to provide the capacity that we all need today.

However, we believe that there is an underlying problem that has to be addressed, and the other speakers here have addressed it. That is the nature of tort reform. Any tort reform proposals that are proposed by the primary insurance industry will have a beneficial effect on reinsurance and will attract capital back in the business and give more reinsurers an incentive to stay in the business and expand their lines of writing.

We are very strongly in favor of tort reform. We also support the new CGL forms which Ms. Walters discussed. We believe that that is an insurance industry effort to improve the availability of insurance. But we believe that the Congress should do what it can to improve the tort reform that we now see going on on the State level.

Thank you very much.

[The statement follows:]

STATEMENT OF THE REINSURANCE ASSOCIATION OF AMERICA

My name is Mindy Pollack, Assistant General Counsel of the Reinsurance Association of America, a trade association of professional reinsurers. Our member companies are professional reinsurers principally engaged in the business of assuming property and casualty (p/c) reinsurance and are either domestic U.S. companies or U.S. branches of foreign reinsurers entered through and licensed by a state. All the companies are subject to the regulatory jurisdiction of the various states in which they are domiciled or licensed.

We appreciate the opportunity to address the dual issue of availability and affordability of reinsurance.

Reinsurance is essentially an insurance transaction whereby the reinsurer, for a premium, agrees to indemnify the ceding insurer or reinsured against all or part of the loss which the latter may sustain under its policies of insurance. It is often described as the insurance of insurance companies because it provides reimbursement for the insurer's losses under policies covered by the reinsurance contract. Reinsurance is purchased by the primary or excess ceding insurer for its own benefit so that it can spread its risks and limit its own liability from large or catastrophic losses. The usual reinsurance contract does not involve the policyholder, who looks only to its insurer for defense and indemnity against loss.

Reinsurance was developed to provide capacity essential to the continued growth of the direct insurance industry. In addition to capacity, reinsurance is purchased by a primary insurer to (1) reduce exposure to liability on particular risks, (2) protect against accumulations of losses arising out of catastrophies, (3) reduce total liabilities to a level appropriate to its premium volume and capital, (4) reduce exposure to certain and possibly more hazardous lines of business or alter its "mix" of business, (5) help stabilize operating results, and (6) obtain assistance with new concepts and lines of insurance.

Reinsurance contracts are shaped to meet the specific needs of the ceding insurer. Despite the fact that there are no standard reinsurance contracts, there are two basic types which are used and adapted to accommodate the buyer's business. A reinsurance *treaty* is a broad and often automatic agreement that covers some portion of a particular class or classes of business, i.e., the ceding insurer's entire workers' compensation or property book of business. In contrast, a *facultative* agreement covers a specific risk of the ceding insurer and requires the insurer and reinsurer to agree on terms and conditions on a contract-by-contract basis. Both treaties and facultative agreements may be based on a *pro-rata* distribution where the two parties share proportionately in premiums and losses. The agreements may also be written on an *excess* basis, where only the losses of the insurer in excess of a predetermined amount, known as the "retention", are reinsured. It must also be noted that many reinsurers also provide *direct* excess insurance to policyholders, although this direct business generally represents a small portion of a professional reinsurer's entire book of business.

The 1984 U.S. property and casualty reinsurance market received approximately $11.3 billion in gross premium. Of this amount, $10.9 billion was for reinsurance assumed and $446 million for direct excess insurance. This represented less than 10 percent of the total net premium written by all property and casualty companies. However, for reasons noted below, the reinsurance industry today absorbs a higher percentage of total losses, and this liability requires a further spread of risk to international reinsurance markets. Foreign reinsurers assume a significant portion of these U.S. risks and, indeed, U.S. insurers paid $1.3 billion more in reinsurance premiums abroad in 1984 than were received by U.S. reinsurers from foreign ceding companies. Much of this premium going abroad is paid by U.S. reinsurers to spread their own risks, and these contracts are called "retrocessions".

Since reinsurers indemnify primary and excess insurers for losses paid under their direct policies, they are impacted by the same legal and legislative developments affecting property and casualty insurers. Any factors increasing the frequency or the amount of losses will increase the reinsurer's liability, although the effect on reinsurers can be even more dramatic than on direct writers.

The insurance industry's enormous and still expanding liability in the casualty area under general liability policies issued in the past has had and will continue to have a major influence on the present and future ability and inclination of reinsurers to continue to expose their capital and surplus in these same lines of insurance, until and unless major reforms in both the policy forms and the civil justice system take place. Experience on current and past policies is creating current and future liabilities of such unanticipated magnitude and unpredictable nature that the reinsurance industry finds it almost impossible to assess its present total responsibility.

Insurance policies and reinsurance contracts written in the 1950's and 1960's for relatively low premiums are now responding pursuant to court decisions or retroactive legislation to claims which were never anticipated under the contracts. The resulting impact on reinsurance has been traumatic.

First, these unexpected liabilities as well as other losses are draining the industry's policyholders' surplus and hence its ability to provide the capacity needed in all lines of reinsurance. Second, these losses have highlighted the totally unpredictable nature of casualty risks and the liabilities which they create and how these, in turn, can be enlarged by the courts and by legislators. Taken together, these forces are likely to discourage the reinsurance industry from writing risks it cannot likely commit most of its available capacity to product lines providing some profit potential. As a matter of fact, a reinsurer will need to adopt this behavior if it wants to remain solvent. It must do so for the benefit of all of its client companies, their policyholders and its shareholders.

As previously mentioned, the reinsurance industry is today absorbing losses from primary insurers disproportionate to the amount of premiums received. This is a relatively recent development. A comparison of the ratio of loss and loss adjustment expenses to premiums between reinsurers and insurers is most enlightening:

	Reinsurers (percent)	Insurers (percent)
1980	75	75
1981	76	77
1982	80	80
1983	85	81
1984	103	88

This supports the contention that changes in the civil justice environment and the interpretation by the courts of insurance contracts in ways never anticipated by the insurance industry have had considerably worse impact on reinsurers than on the primary companies. Note that in the early 1960's, it was common for a reinsured company to offer $5 million or $10 million coverage limits to a policyholder but retain only $50,000 to $100,000, respectively. All losses in excess of those retentions were then intended to be absorbed by reinsurers. However, since it was expected that the reinsureds retention would suffice to cover the majority of losses, the reinsurance premium paid was relatively small.

What has, in fact, happened is that the retention limits of the reinsureds have been pierced with unexpected frequency in just about all lines of business. The result is that reinsurers' past and future liabilities on these contracts are likely to exceed the premium received, plus all the investment income earned on the premium.

The traditional general liability insurance contract leaves the insurer exposed to claims filed many years after the insurance policy has expired since the contract provides for coverage of any loss occurring during the policy period irrespective of when the loss is reported. Certain exposures, particularly in the toxic tort area, are particularly susceptable to this latency factor which is generally referred to as the "long tail".

Although this delay in reporting creates serious problems for all insurers, there is a marked difference in loss development patterns between reinsurers and primary insurers as summarized in the table below. The major reason for these differences lies in the retention feature of excess of loss reinsurance. Since many claims are not valued at ultimate cost initially, the primary insurer may not report such claims to his reinsurer until considerable time has passed because the initial reserve is within the primary insurer's retention. The relative development is much larger for the reinsurer than the primary insurer since the primary insurer's net loss on any particular claim is limited for annual statement purposes to its retention. In addition the primary claim department has more direct control over the administration and adjudication of each claim.

PERCENTAGE OF ULTIMATE LOSSES

	First year		Fourth year	
	Reinsurer	Primary	Reinsurer	Primary
Automobile Liability	35	80	80	100
General Liability (incl. asbestos)	3	50	20	85
Medical Malpractice	2	45	20	90
Workers' Compensation	15	75	40	95

Source: 1984 Best's Casualty Loss Reserve Development (for Primary only).

This delay creates major problems for reinsurers in the anticipation of losses, and, the consequent rating of future business on the basis of accurate loss information. For the past several years we, The Reinsurance Association of America, have been conducting studies in reinsurance loss development trends. In recent years, loss development factors have become larger. With few exceptions, each year's additional information has proved previous loss development patterns to have been optimistic.

Some of the factors that have contributed to these changing loss development patterns are:

1. Automobile Liability—Development is influenced by such things as the rising costs for medical expenses under unlimited no-faults benefits, changes in the guest statutes, changes from contributory to comparative negligence, and changes in social attitude that have an inflationary effect on settlements.

2. General Liability—Similar effects for General Liability exists with respect to changes in loss development patterns. These include changes from contributory to comparative negligence, "social inflation", and medical expense inflation. In addition, retention changes (which also affect Automobile Liability) can have some effect on the emerging patterns of loss development. Mix of business may also be a factor since General Liability includes product liability and other professional liability insurances. As contributing companies may have changed their mix in more recent years, such changes will also have an impact on the development patterns.

3. Workers' Compensation—Workers' Compensation experience is a function of both indemnity and medical costs. Medical costs, as noted above, have been increasing and therefore the impact of such increases will have an effect on the emerging patterns of development. In addition, new developments in occupational disease may have an impact. Also affecting Workers' Compensation are changes in remarriage, mortality assumptions, and retroactive law changes. In particular, mortality assumptions on catastrophically injured cases may have been optimistic. Liberal interpretations by Workers' Compensation administrative authorities may also be a factor. It is also possible that increased legal representation may influence ultimate losses and consequently the loss reserve development patterns. In the Workers' Compensation line over the past few years, however, there has been little deterioration. A possible explanation of this seeming stability may be the recent imposition by reinsurers of more stringent reporting requirements in combination with coverage restrictions under late reporting clauses.

This list of possible explanations is not exhaustive, but it does provide a partial explanation for the trends we have observed. The trends during the 1970's and early 1980's are obvious. The implications for the rest of the 1980's are uncertain. In particular, reserving for latent injury and common cause cases will be challenging in an environment of changing judicial interpretations of liability. Further influencing the factors will be the continuing growth of loss adjustment expense in most lines, but especially in General Liability.

It is no accident that the lines of insurance which are the slowest to develop—the long tail lines—are the ones creating the worse problems for reinsurers. For instance, in the general liability area—even excluding identifiable asbestos losses, by the end of the first year we know little more than 5 percent of ultimate losses, 30 percent by the end of the third year and by the eighth year 60 percent. It is not until the thirteenth year that we know of 75 percent of the losses that will arise and we slowly hear of the remainder of the losses over the next two decades.

Assuming no change in the future loss development patterns, the majority of losses on reinsurance contracts covering general liability exposures issued in 1985 will not be known to the reinsurers until 1993; and, by the end of the century, there will still be large amounts of losses not known by the companies. Note that these losses will be adjudicated in the social, judicial and economic environment which

will then prevail but, the premiums to pay those losses must nevertheless all be collected in 1985.

Finally, it is important to note the potential for complexity of the different coverages making final determination of a reinsurer's ultimate liability in a single risk extremely difficult. Consider *one* reinsurer's potential involvement at the KinBuc Superfund site, where 95 plaintiffs are suing 667 defendants for personal injury and property damage caused by exposure to hazardous substances disposed of at the site. This reinsurer has identified 137 involvements to date. If the exposure period is, say only 10 years, those 667 defendants may trigger thousands of policies. The reinsurer with 137 involvements must review 10 years of policies and contracts just to check on coverage. At another Superfund site, this same reinsurer found 85 involvements in a suit filed against 190 defendants. This particular reinsurer has located involvement in 250 additional sites, each of which could give rise to a similar litigation pattern. The lengthening development patterns and the recently emerging areas of unanticipated liability have made it difficult for reinsurers to properly price the protection they offer.

Is it any wonder then, that the reinsurance industry's underwriting experience over the past several years, has been atrocious? The industry's combined ratio has shown a worsening in each of the past five years, as the following table shows:

U.S. reinsurance combined ratio

Year:	
1984	133
1983	119
1982	114
1981	108
1980	107

A.M. best—1984 Reinsurance Results.

What is also particularly disturbing is that this operating loss in 1984 far exceeded investment income. As a result, the reinsurance industry sustained a 7 percent decline in policyholder's surplus despite a large infusion of new capital in the industry. A.M. Best notes that "the reinsurers posted a negative 14 percent return on surplus" in 1984, as compared to a 3 percent negative return for the total property/casualty industry. Best further notes that today, the ratio of Net Liabilities to Surplus for the reinsurance industry exceeds that of the industry average.

What this all means, of course, is that the U.S. reinsurance industry's capacity has diminished substantially at a time when the need of our growing economy for insurance has increased. It should be noted that the decrease in capacity of the U.S. reinsurance industry coincides with a review of the continued participation in the U.S. insurance and reinsurance markets by Lloyds and other foreign companies.

What about the future? Availability of an adequate reinsurance market depends on two factors:

1. The ability of the U.S. reinsurance industry to build up an adequate policyholder surplus base to sustain growth.

2. A change in the civil justice environment in which reinsurers must operate.

Surplus growth can come from two sources. One, is the funneling of outside capital into the reinsurance industry. The well established companies have been successful in the past several months in attracting new capital either through an infusion of capital funds from a parent or through the floating of stock issues. This certainly demonstrates faith in the ability of the reinsurance industry to come out of its slump and return to a profitable state. Not all reinsurers have been that fortunate, however, and some have served notice of intention to either quit writing reinsurance altogether or to limit their diminished capacity to the more certain lines of reinsurance.

However, even those reinsurers with adequate capacity will funnel their resources in those lines which provide a certain degree of predictability. Predictability is essential to insurance pricing and it should be noted will be substantially enhanced once the new CGL contract forms developed by the Insurance Services Office are approved by state regulators.

Ultimately, the availability of reinsurance in critical product lines, at affordable rates, will depend on the restructuring of our civil justice system. We are encouraged by the careful and objective review which the Senate Commerce Committee is giving to this issue. We believe that the tort system must provide a fair balance and until such a balance is restored, the problems which have been identified for this Subcommittee are bound to persist.

[The following information was subsequently received for the record:]

QUESTIONS OF SENATOR PRESSLER AND THE ANSWERS

Question. Is it true that several major foreign reinsurers will no longer write certain lines of American reinsurance? If so, what are their reasons and what lines are affected? Is it true that Lloyds of London will stop insuring certain lines of liability insurance and if so, what lines have they specified?

Answer. We cannot say that certain foreign reinsurers have stopped writing certain lines of American reinsurance, although we know that overall capacity has decreased due to a withdrawal of some from all reinsurance markets worldwide. This reflects either an insolvency or impaired financial condition. Our members see this development as buyers of reinsurance—that is, U.S. reinsurers also spread their risks through reinsurance (called retrocessions)—and rely heavily on the foreign market for an international spread. We believe that more than 50% of the retrocessional premium dollar goes abroad. The extent to which individual U.S. reinsurers buy reinsurance from foreign reinsurers varies considerably, depending on their retention levels, (similar to deductibles), lines and limits of business, and capacity of the U.S. market. Some members were hit very hard by the loss of retrocessional capacity; others were not. The lines most affected are in the casualty area because they encompass the most volatile risks and potentially enormous claims in our current civil justice system. As a result, it is difficult to predict losses and determine (or get) an adequate rate. The hardest hit lines are environmental, product liability, municipal and medical malpractice risks.

We cannot comment on the decisions or actions of Lloyd's of London, and refer the Subcommittee to Lloyd's and their U.S. counsel for such information.

Question. What are the regulations reinsurers must comply with in the various States? Do those regulations apply to both foreign and domestic reinsurers? Should reinsurers, either domestic or foreign, be regulated more closely?

Answer. Although state regulation of reinsurance varies among the states, the general approach taken by insurance departments is fairly uniform. The principal regulatory tool is the "credit for reinsurance" law, which determines when a primary or "ceding" insurer may treat reinsurance as an asset on its financial statement. Since this asset treatment is vital to insurers, they will comply with the credit for reinsurance law.

Most states allow the domestic primary insurer to take financial credit for reinsurance recoverable if the reinsurer satisfies one of several regulatory alternatives. All states allow credit if the reinsurer is licensed in that state; a reinsurer will be licensed just like a primary insurer and therefore comply with the financial, reporting and examination laws of that state. Most states also allow credit if the reinsurer is licensed in at least one other state if that state applies "adequate" standards and the reinsurer meets the financial requirements of the state where credit is taken (primary company's domicile); this ensures that the reinsurer is regulated in the U.S. to the satisfaction of the other state insurance department. Most states also allow credit where the reinsurer maintains a trust fund in the U.S. in an amount sufficient to meet its U.S. obligations; the Lloyd's trust fund in New York is the best example of this alternative. If any of these options is satisfied, it is generally known as "authorized reinsurance" for the purpose of financial reporting on annual statements filed by all U.S. insurers. If the primary insurer does business with a reinsurer not satisfying any of the above, it must treat the "unauthorized reinsurance" recoverable as a liability. This liability, however, may be reduced if the primary insurer (or reinsurer) establishes security in the U.S. to guarantee the obligation of the reinsurer. This security is commonly a letter of credit issued by a Federal Reserve Bank or a trust fund; in both cases, the money is payable to the primary insurer if the reinsurer defaults.

Credit for reinsurance laws apply to all U.S. domestic reinsurers as well as primary insurers. Therefore, a New York reinsurer must comply with New York credit for reinsurance laws with regard to its retrocessions.

The purpose of the credit law is to give a strong financial incentive to U.S. insurers and reinsurers to buy reinsurance from financially stable, well-regulated reinsurers but at the same time provide an international market. On balance, the collectibility of reinsurance is assured. Since this is extremely important to state regulators, the National Association of Insurance Commissioners (NAIC) developed and adopted a model credit for reinsurance law to encourage the states to strengthen their standards. Is been a successful effort as state insurance departments and legislatures continue to adopt the model law.

As noted, these laws apply to only U.S. domiciled insurers and reinsurers, who must file financial statements in accordance with these laws. The foreign reinsurer is not subject to the insurance laws in the U.S. unless it is licensed, but even then it is regulated to a much lesser degree than U.S. domiciled companies. If licensed in a state, it must file statements, submit to jurisdiction and comply with capital/surplus laws; however, it need not satisfy U.S. credit for reinsurance laws. Please note that some foreign reinsurers, such as Lloyd's, maintain a license in a state, but the majority do not.

Reinsurers are regulated in other areas, particularly where the reinsurance is between affilates or in any way raises solvency questions with the state regulator. For example, many states carefully regulate reinsurance agreements involving "surplus relief" by requiring full disclosure and proper accounting. After a primary insurer becomes insolvent, the state regulator must protect the reinsurance asset due the primary insurer and therefore takes steps to ensure that the reinsurer pays the full amount due under contracts to the liquidator. This allows a distribution of assets, including reinsurance, to all creditors in accordance with the insurer liquidation laws of the state.

There are certain areas where reinsurance is not regulated, and these largely concern the contractual aspects of the business. The rate-making laws do not apply to reinsurance agreements. The policy form laws also do not apply. These two exceptions were carved out and maintained because reinsurance is conducted by two insurance companies, who shape the reinsurance contract to meet their particular needs. Reinsurance, unlike primary insurance policies, has no standard form and indeed, it developed so that individual primary insurers could shift risks through individually tailored agreements in accordance with their book of business and philosophy. As noted earlier, some insurance departments regulate certain types of reinsurance agreements, and a few require the filing of all reinsurance contracts. However, the "ordinary" reinsurance agreement need not be filed or reviewed in the majority of states.

These laws provide an important balance, and any change should be carefully considered. The RAA would favor strong credit for reinsurance laws and the enforcement of such laws. We encourage all states to adopt the NAIC model law because it provides security to U.S. insurers and the needed international capacity. If a foreign reinsurer does not maintain the trust fund or letter of credit in the U.S., then the U.S. insurer or reinsurer should not be entitled to any financial benefit. However, we should not prohibit foreign reinsurers from doing business here because their capacity is essential to U.S. companies. Again, we must strike a balance and most state laws—if enforced—do this or are moving in this direction.

As for policy and rating laws, any changes would dramatically alter the nature of the reinsurance business. While we would say that major changes are not needed, we point out that state regulators do address these areas where an abuse or solvency concern is present. The states have the necessary authority to regulate contracts if they threaten solvency, distort financial statements or harm policyholders. Again, a balance has been reached over the years.

The major point here is that states have the tools to regulate U.S. reinsurers and certain reinsurance contracts. Most states use them and we are encouraged by the improvements in other states.

Question. What percentage of the world-wide property/casualty reinsurance market did American reinsurers capture in 1984?

What percentage of the American reinsurance market was captured by foreign reinsurers?

Answer. We do not have adequate data to answer these questions, but other figures shed some light on the breakdown between U.S. and foreign reinsurance premium. To our knowledge, U.S. primary (i.e. ceding) insurers give almost 75% of their reinsurance premium dollars to U.S. reinsurers. The foreign market becomes more important at the retrocessional level. U.S. reinsurers give more than 50% of their retrocessional premiums to foreign reinsurers.

Unfortunately, most studies of U.S. and foreign reinsurers do not distinguish between the reinsurance and retrocessional levels. However, using these broad reinsurance studies, it is apparent tht far more reinsurance premium goes abroad than comes here. According to the 1985 Annual Commerce Department Study, U.S. insurers/reinsurers paid $1.3 billion more in premiums to foreign reinsurers/retrocessionaires than foreign companies paid U.S. reinsurers/retrocessionaires. Results from previous years are consistent. The United Kingdom and Western Europe, in general, are the major recipients of the U.S. reinsurance premium dollar.

Question. Apparently the reinsurance industry is suffering from the same problems as the primary insurance companies. What is the resulting capacity shortage

in the reinsurance market, if any, and how is it affecting the primary insurance market?

Answer. It is difficult to measure the lost capacity, even for a single company, and its effect on the primary insurers. There are several reasons for this. First, we cannot determine if a reinsurer is actually offering lower limits or different terms (i.e. exclusions, conditions, etc.). This varies by contract. Second, since premium levels have risen recently, the written premium levels do not provide any measure of lost capacity. Third, the effect of any lost capacity varies with the primary insurer. Some primary insurers retain a large percentage of their risks and have little reliance on reinsurance; others may cede up to 50% of their gross premiums.

Conning & Company recently published a study entitled, "Reinsurance Use and Cost of Reinsurance Versus Benefit." The study focuses on 26 primary insurers, and draws the following conclusions:

1. The utilization of reinsurance varies widely from company to company. For example, AIG ceded 46% of its 1984 gross premiums while Progressive ceded less than 1%. The average utilization over a 10 year period was 16.6% (premiums ceded).

2. The extent of utilization increases with the size of the primary insurer. The larger primary insurers tend to write the commercial risks, which require significant reinsurance.

3. The extent of reinsurance utilization has increased over the past 10 years from an average of 10.7% in 1975 to 16.9% in 1984. This has occurred despite increasing retentions of primary companies, probably due to the competitive reinsurance market.

Although we cannot put a figure on lost reinsurance capacity, the decreasing number of reinsurers is a good substitute. The 1984 RAA Reinsurance Underwriting Review (compiled in 1985) collected data from 18 fewer organizations that it did one year earlier. In addition, we know that several of the reporting reinsurers had cut back or eliminated any writings in certain lines, such as casualty business or facultative certificates. An informal survey found that 51 U.S. reinsurers had withdrawn totally or partially from the reinsurance market during 1984 and 1985, many of which are in liquidation/rehabilitation or simply running off their existing business to protect their solvency. This loss of capacity is very significant.

Question. Why have the limits assumed by primary insurers been exceeded so frequently, particularly in the "toxic tort" or other long-tail liability areas?

Answer. Primary insurers have passed comparatively more of their losses than premiums on to reinsurers for several reasons, although the "long-tail" nature of the casualty business is an important factor to each. Consider the findings in our enclosed Loss Development Study, which indicates that 75% of the losses in general liability were known to reinsurers only by the thirteenth year. (This excludes asbestos liability, which slowed loss development considerably). In other words, a reinsurer will determine rates and coverage in 1972 but not know of the loss until 1985, when it must establish a reserve and prepare to pay for that loss in the 1985 legal climate. If we are looking at lines that involve emerging and changing theories of liability, the reinsurer will find that it woefully underpriced the coverage. Moreover, it will not know of this mistake for many years and cannot correct the rates and coverage for some time. In addition, these casualty lines of business also involve scientific changes more than any others. We have learned that asbestos and certain chemicals cause injuries, but well after reinsurers provided years and years of coverage. These "toxic tort" areas are the most serious for reinsurers because they involve both new liability theories and new scientific knowledge as well as the latency factor injuries themselves!

Therefore, reinsurers paying asbestos losses today, for example, are probably referring to the reinsurance contracts issued in the 1950's, 1960's and 1970's—well before the industry knew the extent of its potential liability under court interpretation of insurance policies and tort law. Since reinsurers could not foresee the severity or frequency of these losses, they established premium and rate levels based on conditions as they existed at that time. In general, retentions were fairly low and reinsurance premiums were also low, especially at the higher layers. That is, a reinsurer at the $10 million level (losses exceeding $10 million) will receive a much lower premium than the reinsurer at the $1 million level. Obviously, the reinsurers at higher levels do not expect to see their layers pierced often, and the premium reflects this.

However, the casualty losses hitting reinsurers now for coverage provided 10, 20 or 30 years ago are more frequent and severe than ever expected. Consider only the impact of asbestos and hazardous waste cleanup liability (which is retroactive, strict, and joint and several under Superfund) and the impact is clear. Could reinsurers

envision 20 years ago that hazardous waste cleanup costs ranging up to $100 billion would largely be passed on to insurers and their reinsurers? It is probably more important to see that this unexpected liability will be with reinsurers for many years, due to the long tail problem. For example, we know that cleanup costs will "hit" reinsurers shortly and continue well up to the year 2000—but this liability is tied to contracts issued before the liability was ever expected. Reinsurers must reserve for these enormous losses in order to protect their solvency. Thus, the effect of increased and unexpected frequency and severity of losses in the casualty lines will plague reinsurers for some time.

The Conning & Company study noted earlier also reaches the conclusion that reinsurers are hit harder by the liability explosion than primary insurers. It reports:

"For all primary insurers over a ten year period, 116.4% of the cost of reinsurance was returned to the primaries in the form of paid losses or collectible losses. This ratio deteriorated for reinsurers, growing to 121% in 1983 and 173% in 1984."

Question. As I mentioned in my opening statement, I have been somewhat frustrated by the lack of any hard evidence linking liability insurance rates to the tort laws in particular States. Could RAA develop information in this area, such as:

(a) The percentage of claims paid by reinsurers that were the result of court awards;

(b) The record of court awards paid under particular lines of coverage and premiums in those lines?

Answer. The RAA does not develop its own data in these areas and can only refer you to studies conducted by other organizations.

We suggest that you review another recent Conning & Company study entitled "Crisis In Liability Insurance: A Time For Change" (November, 1985). This study reports liability trends in many lines and contains much of the information you seek. We will highlight just a few of the findings:

Million dollar verdicts increased to 400 in 1985 from only 80 in 1979

New product liability cases in federal courts more than doubled between 1979 and 1985

The average product liability award in 1984 was over $1 million

The percentage change of indemnity losses plus expenses has increased more than premiums in the first 6 months of 1985

The number of punitive awards in Cook County and San Francisco increased from 18 in 1960–64 to 135 in 1980–84, nearly doubling in that 10 year period

The average punitive award against commercial defendants in Cook County increased 264% from the 1975–79 to 1980–84 period. However, the median award has increased but not nearly as dramatically.

This and recent Rand studies *do* provide some hard evidence linking insurance rates to the tort system, and we suggest that these studies be reviewed carefully.

Question. How does the reinsurance industry determine rates? Are rates set on a state-by-state or nationwide basis? What is the relationship between claims incurred and premiums charged?

Answer. Reinsurance rates are keyed more to the rates charged by the primary company than the underlying risk. This is because a reinsurance treaty typically covers a primary insurer's entire book or line of business, or a layer thereof. This book of business may include risks in all or many states. Consider if Allstate, a nationwide writer, reinsures its entire automobile business in a single reinsurer. It is impossible for the reinsurer to even be aware of all the policyholders, never mind set individual or state-by-state rates. Rather, the reinsurer relies more on the total premium established by the primary insurer, who writes the individual risk and can assess premium on a state-by-state basis. For example, a primary insurer may issue a $1 million dollar policy for reinsure losses in excess of $100,000 (Note, we chose there numbers for example purposes only!). The primary insurer, using manual rates, charges a premium based on the $1 million limit; the decreasing rate. This reflects the fact that losses at lower levels (say $25,000) are far more likely than losses at the higher levels (say $900,000). The reinsurance premium follows this rule. It is based on the portion of the primary premium that is charged for the amount exceeding the retention. In the above example, if the total premium was $10,000 but only $4000 of this was charged for the top $900,000 coverage (the amount reinsured), that $4000 might represent the reinsurance premium. This simply illustrates the point that frequency and severity of claims—i.e. expected number of losses in excess of retention—determine the reinsurance premium. That premium necessarily decreases as the coverage reaches higher and higher layers. Consider the same $1 million policy example with three reinsurers, each with a $300,000 layer above the $100,000 retention. The reinsurer with the $100,000 to $400,000 layer will receive more premium than the reinsurer with the $700,000—$1,000,000 layer. Claims fre-

quency and severity, therefore, directly affect premiums. This includes claims incurred and claims expected in the future, because the premium charged today must pay for claims in the future.

Question. How do agreements between primary insurers and reinsurers affect the coverage and premiums offered by the primary insurers?

Answer. Reinsurance contracts affects the coverage offered by primary companies in the specialty lines. The reinsurance industry is a very competitive, diverse market where companies specialize in the lines where they have the most expertise. Many commercial lines, which involve the most volatile and complex risks, are written by such reinsurers. The recent market constriction has forced reinsurers to cut back most in these lines, and primary insurers have had difficulty securing alternative reinsurance arrangements. Thus, primary coverage may shrink, due in part to lessening reinsurance capacity.

As noted in the RAA response to No. 8, reinsurance rates are typically based on primary insurance rates, particularly with long-term treaty business. The reinsurer may exercise more influence over premiums where facultative reinsurance is desired, as this covers specific risks of the primary insurer. The reinsurer and primary carrier tend to work more closely in evaluating and rating where facultative reinsurance is involved, often because the reinsurer provides expertise to the primary company and also due to the shorter terms of the arrangement. Please note that only 11% of all reinsurance represents facultative arrangements.

Question. The current problems in the insurance industry has been attributed to poor underwriting practices, shortcomings of the civil justice system, and the cyclical nature of the industry. Could you please rate, on a 100 point scale, the relative importance of those three factors, or any additional factors, as causes of the current "crisis?"

Answer. All three factors certainly contributed to the current "insurance crisis." I would rank them as follows:

	Percent
Civil justice faults	50
Poor underwriting practices	25
Cyclical nature of industry	25

I would like to comment, however, on "poor underwriting practices." Some believe that cut-throat competition led insurers and reinsurers to charge inadequate premiums, and that high investment returns allowed this practice to continue. We agree, but ask if this is a "poor underwriting practice." We do not think it improper for reinsurers or insurers to lower premiums for the benefit of insureds if investment income compensates for this rate decrease. Consider what the policyholder's response would be if insurers and reinsurers reaped high returns and did not reduce premiums. It is to the policyholders' benefit that the insurance industry is as competitive.

Where the industry may have exercised poor underwriting judgment was failing to foresee and react to the rapid and dramatic changes in our civil justice system. It is this failure that represents our 25% rating, although we seriously question how much change anyone could foresee. Indeed, if insurers and reinsurers charged a premium in, say 1975, in anticipation of Superfund, asbestos, DES, increasing punitive damage awards, million dollar verdicts, etc., we suspect that policyholders—along with regulators and legislators—would be making the same criticisms they are making now.

How does the insurance industry set rates? For example, are rates for commercial auto insurance set specifically for South Dakota or are they set on a nationwide basis?

Ms. WALTERS. Senator Pressler, generally for almost all lines of insurance that I can think of, rates are made by coverage, by line, and by state. So that whether you are talking about commercial auto, whether you are talking about municipal liability insurance, whether you are talking about homeowners or private passenger auto, rates are made on a State by State basis.

Senator PRESSLER. Then why is South Dakota, for example, paying such high rates? Some organizations are experiencing rate increases up to 1,000 percent, when I am told that their claims are not nearly as high as States like California and New Jersey. And I am not picking on California and New Jersey.

Ms. WALTERS. I understand.

One of the previous witnesses addressed this question to some extent, and I believe the answer was certainly going in the right direction. In ratemaking what we do is analyze the experience of the most recent past and apply trends to the extent that we can quantify them, whether they are trends in claim cost and claim frequencies, in order to estimate the loss level that is anticipated to prevail when the new rates go into effect.

Well, that is a lot of fancy words, but it sort of summarizes what the actuarial process is in determining needed rate level in the future. There is a difference, though, between determining rates that a ratemaker would do, whether you work for an organization such as mine or for an insurance company, there is a difference between ratemaking and pricing.

Pricing involves taking the rates as determined by the actuary and effectively putting them into the marketplace. And a great deal of judgment is needed, particularly for the commercial lines of insurance, which tend not to be so much class-rated as individually risk rated. That is, the individual underwriters must take into consideration other elements in a judgmental way that cannot quantitatively be factored into the ratemaking process.

I think to some extent this is one of the reasons why you might see that rates for the various commercial lines are moving in what might seem like an unpredictable fashion to those who are going to be paying them.

Let me add one other thought to this, though. And in some ways your question could be rephrased by someone who is purchasing auto insurance and say, that person might say: Gee, I have never had a claim, but yet I have to pay more for my auto insurance each year; the rates keep going up.

And the answer is essentially the same. The answer is that not everyone is going to have a loss, not everyone is going to have a claim, but what we try to do is rate the experience for all of the people in the same class. Not everyone is going to have a loss, but those who do must have those losses paid for by the insureds who are in that same class.

Mr. HUNTER. Mr. Chairman, I would like to comment, if I could, on that.

Senator PRESSLER. Yes. Just let me say that any empirical evidence you can submit to the committee in terms of numbers or comparisons on that question—and I ask that in a friendly sense—would be appreciated. I would like some empirical evidence, some statistics, if we could.

Mr. HUNTER. Yes.

I am also an actuary, like Ms. Walters. The ratemaking question is a very important one. Normally the rates are established on an annual basis. The small businesses will pay an annual rate, and it is done for most lines of insurance on a State by State basis.

You get into very small lines where they have to look beyond a State border sometimes for ratemaking data. One of the key problems that I think Ms. Walters mentions is the ratemaking versus pricing. Right now, half the States rely on competitive pricing. Now, if you are in a line of insurance where you have one or two companies competing, how do you possibly expect competitive pricing to hold rates to a non-excessive level?

And yet many States are continuing to rely on competitive pricing, even in this current condition. And to rely on that I think is highly suspect, given the kind of problems you have alluded to in terms of your constituents coming forward and saying they cannot get it.

Additionally, half the States use prior approval, and the insurance industry has manipulated this crisis in such a way as to greatly intimidate, to my estimation, the State regulators who try to regulate on a prior approval basis. One of them told me that he wanted to limit a price increase to about 25 percent and was told by one of the two remaining companies in the line, we will leave the State if you do that, even though his actuary told him 25 percent was the right number.

You can imagine the position he was in. He approved in excess of a 100 percent increase.

Senator PRESSLER. If we could have you both submit as much empirical evidence on those points, I would much appreciate it and we may put it in the record.

My final question—and I have several for the record, but for this question I would like to have Mr. Hunter respond first, followed by Mr. Kimble and Ms. Pollack, and then have Ms. Walters respond to all of their comments.

The question is, what is your reaction to ISO's new claims-made policy?

Mr. HUNTER. I think it should be disapproved in every state, especially for small businesses, for several reasons. First of all, I do not think particularly small businesses are going to have the capacity in many respects to understand it. You are talking about retroactive dates. If you move them up, your price goes down. I can see sharp-dealing agents coming to a small business person and saying: Look, I will cut your premium in half and then move the retroactive date up, and if a claim comes from that and the person is not smart enough to pick that up by detail, they are going to be hurt.

Additionally, one of the major features of it is they remove pollution coverage from the policy and they do not give one penny of discount in price for the removal of that pollution coverage, and that is just wrong.

Mr. KIMBLE. I emphasized our problems associated with insuring multiple causation, long latency diseases. You simply cannot insure a long latency exposure on an occurrence based contract. We ran into a great deal of difficulty with an occurrence based contract in the long latency situation in the past.

Asbestos-related injuries is one example. Those contracts were occurrenc-based and we are now paying claims in 1985 based on contracts which were written in the 1930's or 1940's. We cannot price our product in that fashion because we cannot predict societal litigiousness, changes in the tort system, such as the Bashada case, which does away with the State of the art concept associated with asbestos.

A claims-made policy is absolutely essential if the insurance industry is to write long latency disease situations.

Ms. POLLACK. The reinsurance industry certainly supports the new CGL forms. In particular, we support the move toward a claims made form from an occurrence, and the reason is that the reinsurance industry has probably been hit harder by the old occurrence form than the primary insurance industry. And that is again the nature of the business.

It is known as a long tail business, in that once an occurrence takes place, it is many, many years before it reaches the reinsurance industry for a payment to the primary insurance company. That very long time period between the initial occurrence and the reinsurance payment makes it very difficult for a reinsurer to price the product.

If insurance is being offered today, it must look to the legal environment of perhaps 10 years, 15 years from now, to determine what the ultimate payout will be. That is a very difficult process for a reinsurance company in pricing a product. So definitely the reinsurance industry favors the switch to a claims made form. We believe it will improve predictability dramatically.

Ms. WALTERS. Mr. Chairman, let me start by emphasizing and stating most emphatically that the new ISO CGL program with both the claims made and occurrence form we believe is an extremely valuable and important program that we hope will become operational in the United States beginning January 1 of 1986.

Let me also emphasize that the claims made form, which is a part of this new program, is unlike any other claims made insurance contract that exists in the United States or anywhere else throughout the world today. It is different because it has built-in policyholder safeguards and enhancements to make certain that there are no gaps in coverage.

I would also State that there are—there have been some changes made in the CGL form specifically to respond to some of the concerns of some of the agents' associations and buyers. We now have manual rules which talk about when the retroactive date can be advanced and when it cannot. We have included for no additional charge a five-year automatic tail on the claims-made program. And we have guaranteed

the option, the purchase of unlimited tail coverage at the option of the insured.

Let me just close by saying that I believe that those who are running businesses, whether they are small businesses or large businesses, are perfectly capable of understanding the insurance contract and understanding this coverage, particularly with its enhanced policyholder safeguards. I would also note that both of the major national producer associations, the Independent Insurance Agents of America and the Professional Insurance Agents, have endorsed the claims made form.

We are very pleased with this program and we do believe it is going to be very helpful both to small businesses and large businesses, particularly during these very difficult times.

Senator PRESSLER. Thank you.

I do have additional questions for each witness which I will submit for the record.

Senator Rockefeller, if you would ask your questions, then call the next panel, I would appreciate it. And I will hurry back.

Senator ROCKEFELLER [presiding]. Thank you, Mr. Chairman.

I might ask this to either Mr. Kimble or Ms. Walters. There is an instinct in hearings of this sort to kind of, you know, it is everybody else's fault and the remedy is always the remedy which does not affect us, or you or whoever. Now, it has been said that in the good years, so to speak, the 1979 to 1983 years and maybe just a little bit beyond that, interest rates were high, insurance companies offered policies at bargain rates in order to generate the investment income.

Interest rates went down and there were problems. Now, does the insurance industry consider that it has any role to play or that it has any fault, that it could have done things differently or it should have done things differently with respect to the problem? For example, with respect to municipal insurance, is the insurance industry flat clean on this? Is it everybody else's fault?

Ms. WALTERS. No. I do not think I would ever say that, Mr. Rockefeller.

Senator ROCKEFELLER. Could you talk about what could have been done differently?

Ms. WALTERS. Well, let us make sure we understand how we got where we are. Clearly, one of the reasons——

Senator ROCKEFELLER. I think I understand where we are. The question is what could have been done differently.

Ms. WALTERS. I am not certain that there is anything that any one person or segment of society of legislative body could have done. I do not think there is anything any of us could have done necessarily that would have changed the outcome.

The reason I say that is because it was really aggressive competition primarily or in the first instance which led to the very low prices that were charged for the insurance products. I do not believe that if insurance companies or anyone else went to a legislative body and said, please pass a law preventing insurance companies from charging low rates, that it would have been received with great enthusiasm. I do not

believe the buyers would have said no—or would have said, yes, we want you to prevent these insurance companies from outbidding each other and offering us the product at very reasonable rates.

I do not think that could have happened or would have happened. I do not think there is anything that anyone can do ultimately, really, which affects interest rates, which was one of the factors that led to aggressive competition, a very short period of time when there were extremely high interest rates, leading to high yields on investments.

And I would also say this, that insurance companies, while they were competing aggressively with each other and they knew they were underpricing the products, they knew they were underpricing it strictly from an underwriting standpoint, but they fully expected that the investment income would make up the difference between the underwriting loss and their overall predictions of profitability.

Insurers did not embark on this course with the intent of suffering operating losses. They thought they would be able to continue to make a profit.

There were two other elements that are beyond the control, I believe, or were beyond our control at the time we were going through this. We did not realize what was happening. Two things which are not cyclical in nature. One of those is what I call consumer and complainant expectations, and Congressman Porter referred to it earlier today.

We have in our society today more and more of an ethic that, well, if someone is injured someone else will pay and pay dearly. And that is not a cyclical thing. What we have observed is that during this period of time when those underwriting losses were going down, that consumer expectations and claimant expectations have been ever-increasing and expecting greater and greater awards.

The other element that has been taking place in the same time has been court interpretation of insurance contractual language beyond anything that any of us would have predicted or could have predicted. We have very clear language in our policies saying, for example, we will not pay for pollution damage unless it is sudden and accidental. But then there have been court interpretations that clearly take incidents which are not sudden, but which occurred gradually over a long period of time, and saying, we are not going to honor the exclusion, we are going to make you pay.

These kinds of things have been happening during these last 5 and 6 years, some of it just within the last 1 or 2 years. And I do not know what any of us could have done to prevent that.

Senator ROCKEFELLER. Although you do suggest a resolution, you say.

Ms. WALTERS. Two resolutions. I would remind you, Senator Rockefeller, one of the things is, as I indicated, over the last several years we as an industry have been saying what can we do to retain some kind of semblance of control over this product which we are selling, how can we write our language, how can we deal with these long tail liability lines.

We have been working on that, and the culmination of that work is the new commercial general liability policy program. So we have been doing things internally as well. At the same time, the trade associations and the lawyers have been looking at the problems and saying, well, okay, we can redefine the product so it is one that we can price and sell with some certainty.

But what about the rest of society? How do we live with this? Do we want to live with this or should we make some changes that we would recommend to society? And those are the tort reform changes.

Mr. KIMBLE. It clearly could and will be suggested that insurers competed too hard for the premium dollar in order to invest it. However, it has to be emphasized that that competition inured to the benefit of the policyholder. That policyholder experienced a vastly discounted product. It got its product very cheaply.

Also what has to be emphasized is that those insurers who did not discount dramatically lost a portion of their market share, and market share is very important to individual insurers, just like market share is in the automobile industry. And for those insurers who did not compete dramatically for the premium dollar and who did not discount dramatically, they experienced a loss of their market share.

Senator ROCKEFELLER. Would you support some kind of a regulatory mechanism at the State level where bad risks are assigned a pool and, therefore, better risks are assigned more reasonable rates?

Mr. KIMBLE. There are currently assigned risk pools for workers' compensation and for private passenger and commercial auto insurance. There are other artificial, involuntary insurance mechanisms which can be structured at the State level and have been in the past.

The best example is in the midseventies the insurance industry was very concerned about insuring or intimidated by the exposures associated with medical malpractice. A particular company which had no experience in medical malpractice undercut the rates of the traditional medical malpractice insurers for the large medical societies, particularly in the east. It experienced severe underwriting losses and got off those exposures and the traditional insurers did not get back on them. And in those states, joint underwriting associations were set up to respond to medical malpractice.

The essence of a joint underwriting association is, if you do business in a particular line or in any liability line in a state, then you must participate in this artificial or involuntary insurance mechanism proportionate to your premium volume in that line or all of the liability lines in that state, or you must leave the state.

So there are artificial or involuntary insurance mechanisms available.

Ms. WALTERS. Mr. Rockefeller, I would like to respond to that also if I might. One of the great difficulties that we are all dealing with, in fact one of the reasons we are all here today, is that there is a limited capacity by the insurance industry to write insurance business. It is true today.

In fact, it is true theoretically at all times. That is, a company cannot just hang out a shingle and say, I am an insurance company and I am going to write all the business that walks in the door. You are limited by the amount of surplus that you have. Surplus is net worth as it would be known by the same concept for a commercial establishment. But the surplus or net worth limits the amount of business that you can write, because that surplus stands behind every insurance policy in the event you misprice your product either knowingly or unknowingly, or in the event there are catastrophes or something.

So there is a limited ability to write insurance today. That is further limited because of the disastrous underwriting and operating results of the industry, which are continuing, as I said, into 1985. The laws of supply and demand work in the insurance business the way they work anywhere else, and we have got a situation now where there is a great deal more demand for insurance than there is supply that can be provided by the insurance industry today.

That means, of course, that insurers are going to look to provide this limited capacity to those lines of insurance, those coverages and those states, where they believe—it is their money at risk—where they believe they stand a more reasonable chance of generating an operating profit, and they are going to seek to avoid those lines where they believe they cannot price their product accurately, regardless of the cost.

And to force an industry with a limited capacity to provide insurance in all areas, regardless of what they are, does not deal with that underlying problem of limited capacity. So there is that which must be borne in mind.

And the last thought I would throw out is that when you are dealing with forcing unwilling sellers to provide their product, I do not know how that deals with or if you would intend to deal with the affordability problem. You may be able to say you must provide it, but then if you do that you would have to have them provide it at at least a price they thought was appropriate.

So that may not deal with the affordability problem for some insureds.

Senator ROCKEFELLER. Mr. Hunter?

Mr. HUNTER. Mr. Chairman, the question of limited capacity of this industry is a red herring. There is no limited capacity. According to the executive letter of the Insurance Information Institute of yesterday, the policyholder surplus has grown by 9.7 percent so far this year to $66 billion from under $60 billion at the end of the year. The written premiums were about $103 billion. The ratio of premium writings to surplus is therefore roughly 1.5 to 1.6.

Historically, this industry has written at 2.0. It is writing below its historical capacity levels currently.

Senator ROCKEFELLER. Can you rebut that, Ms. Walters?

Ms. WALTERS. Certainly. Yes, there has been an increase in surplus, as my formal statement mentioned. The increase in surplus money coming into insurance companies has not come from insurance operations. It has been coming from these very unusual things that have been happen-

ing with what I will call peripheral funds, not the bulk or the major source of funds to the industry.

It has come about through the realization of capital gains, companies selling off assets to realize capital gains. It has come through some still I think about a billion dollars worth of tax credits that some insurers have been able to realize.

It has come from funds external to the insurance industry. That is, companies have been successful in going to external sources to get additional funds to shore up their surplus so that they can continue to write business. And it has come from other miscellaneous surplus changes, such as you may have read about and which are common not just in the insurance business but in other corporations today.

Pension funds that have built up a surplus because, you know, what has happened in the stock market, particularly in the last few months, but in the last year and a half. We have had a runup in the stock market. So pension funds have been closed out, the excess assets taken back into the insurance company, and new funds, defined benefit plans as opposed to defined contribution plans, have been enacted.

This has provided a source of funds to companies. And companies have limited and been reducing over the last 2 years their dividends to stockholders. So all of these external things have helped to build up the surplus.

The fundamental operation of the insurance business, the underwriting and all of the investment income that that generates, the bulk, 90 to 95 percent of the funds that come to insurance companies, are still in the red. They are still generating alarming pre-tax operating losses. The first 9 months of 1985 showed a $3.5 billion operating loss.

There is a small improvement in the combined ratio, the figure I mentioned which just deals with the underwriting, a small improvement to about, from 118 last year to about 116 this year. But that is not coming from the loss side. The losses are not getting better. That is coming because there has been a savings in expenses.

The situation—and we in the insurance business are not proud of this, Mr. Rockefeller, but unfortunately the situation from a financial standpoint is still rather distressing.

Mr. HUNTER. The reason the stock market has gone up 44 percent this year is that the Wall Street analysts all have the property casualty stocks on their buy lists. The reason they have them on their buy list is they expect the rates of return on net worth by the fourth quarter of 1986 to at or above 20 percent.

And these things that Ms. Walters calls unusual, I would refer you to the GAO on the tax question. Over the last 10 years, GAO showed that there were underwriting losses of $40 billion, but there was investment income of $110 billion, for a net profit of $70 billion. And the property casualty insurers actually paid negative Federal taxes on that $70 billion profit, according to the GAO.

Ms. WALTERS. I think there was one thing in that statement that I agreed with. That was that stock analysts do expect the return on equity for the property casualty industry to improve. It is hard for an industry

to get much below 1.7 percent, which is what it was in 1984. It is improving.

But I would very strongly disagree that any even average stock analyst expects the property casualty industry in 1986, 1985, or 1986, to earn something even approaching the number that Mr. Hunter suggested.

Let us also remember that stock prices reflect one and only one thing, and that is consumer or owners' expectations. They do not predict profitability. They reflect expectations, and certainly the expectations have to be that profits in the insurance industry are going to improve and at least some signals are that there is an improvement under way.

It has not been shown yet in the bottom lines. Some of the signals that show improvements under way is that the industry is getting control of its destiny by raising prices from those very distressed low levels.

I would suggest that the further prove that stock market prices are not indicative or proof positive of what investors or of what is actually going to happen with profitability would be to look at any chart which shows prices of insurance stocks for the property casualty industry, and I think you will find it very interesting if you compare that chart with the actual chart of insurance returns on net worth, because you will see that the stock market prices have in fact risen rather dramatically over the last 6 or 7 years, but yet rate of return on equity for the property casualty industry has gone steadily downward over the last 6 years.

So analysts' expectations certainly do not predict profitability.

Senator ROCKEFELLER. Basically what I can absorb from what you have said about industry responsibility with respect to all of this, is that the industry is not very good at predicting.

Ms. WALTERS. Unfortunately, that is correct. We have not been terribly good in most recent years, that is correct.

Senator ROCKEFELLER. I want to thank the panel very much, and I would remind myself and all others that it is 12:10 and we have two more panels to go.

Thank you.

Could the third panel come forward, please: Ms. Canter, Mr. Fritzel, Mr. Heydinger, and Mr. Sherlock. Mr. Sherlock, you were the first in place. Do you want to lead off.

STATEMENTS OF NORMAN SHERLOCK, PRESIDENT, AMERICAN BUS ASSOCIATION; LOUISE CANTER, ON BEHALF OF THE INDEPENDENT INSURANCE AGENTS, INC.; RICHARD HEYDINGER, DIRECTOR, RISK MANAGEMENT, HALLMARK CARDS; AND CHARLES H. FRITZEL, ASSISTANT VICE PRESIDENT, GOVERNMENTAL RELATIONS, NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

Mr. SHERLOCK. Thank you, Mr. Chairman. We appreciate this opportunity to testify on behalf of our 3,500 members. They run the gamut in the travel and tourism industry from motor coach tour and charter

operators to theme parks and to sightseeing services to hotels, motels, and restaurants, and various travel promotion entities, as well as just about every State in the country.

All of them are affected directly or indirectly in some way by this insurance crisis. The action or influence of the Congress is essential in addressing this problem because it is nationwide in scope. It is simply not isolated to a state, nor to any particular region.

In order for the problem to be resolved, the determination and the imagination of the Congress need to be brought to bear on it. There is no time to stand off now simply because the insurance industry is not Federally regulated in a comprehensive way.

Throughout the tourism industry, the insurance crisis has been felt as various companies are either unable to get insurance or have to pay astronomical rates to acquire it for liability. And it affects the ability of many of our members and many others either to make a profit or in fact to stay in business at all.

It is not clear that the State governments can handle this problem. We have asked for help there and have written all of the State governors, but it may simply be too big for them. It is, after all, a national problem. The scope of our dilemma can be seen in the example of various segments of the association and the travel and tourism industry. Let me give you some examples.

One motor coach tour operator who paid $120,000 a year for his coverage now has to pay $775,000. A theme park that paid $100,000 on his insurance in 1985 will pay $665,000 next year. A 205-room hotel that paid $38,000 will have to pay $100,000. A snowmobile rental operator with 600 units in Yellowstone could not get coverage at all as of last week. And the biggest one in Minnesota, as I understand it, has now gone out of business.

This is typical of what's happening. The results are predictable. At the last, the price of tourism services will go up where companies can adjust the rates. Where businesses can raise prices without pricing themselves out of the market, they will of course be forced to do so. But that is not an option that is open to everyone.

The hotel will have to realize at least a three percent increase in business generally just to offset that increase. The motor coach operator is caught in a vise. He does not make enough profits to offset that cost and he cannot raise his rates due to competition. So his answer is to reduce his fleet and try to sell half of it in order to stay alive.

Some of them will not be able to stay in business at all, as is the case with the Shubat Bus Company. It went on the auction market and has been sold. Others are in a similar type situation.

Now, the resentment of our members would not be so high if the insurance companies' actions had not been so dramatic and so drastic or if we really felt that we were paying for our losses and our fair share. But as far as we can determine, there appears to be very little correlation between the records of our members and the astronomical rates that are being exacted.

The operators in the travel tourism industry are bearing a disproportionate share of the burden for the insurance companies' problems. We do not believe that the insurance industry has singled us out, but it seems evident that we and others in effect are being forced to pay for its past bad judgment.

At the same time, we recognize the insurance companies are not totally at fault, but the problem does arise in part from our judicial system as well. As long as there is no sensible limitation to litigation by everyone and while judges keep expanding the definition of liability, while juries produce astronomically high awards, the problem will not be resolved.

The whole issue of the judicial framework of the country needs to be addressed. Now, given this background, what can be done?

First, continue and intensify the Congressional inquiries to determine the facts about what has been brought about as a result of the past and the degree to which these astronomical rates are really warranted. Congress should give careful consideration to regulating insurance companies in some way in order to curtail abuses. Insurance companies should be made acutely aware that, if they are going to engage in a guaranteed, almost absolute no-risk, high profit activity, that will be balanced by some accountability in order to protect the public.

Second, the transportation and travel tourism industry need to do everything possible to help themselves, and we will. We have advised our people to take individual action to increase their deductible limits, and in some cases larger entities can look at self-insurance.

But that is not going to resolve the broad problem, and we are looking at a summit conference of the industry at some point to develop, focus, and maximize its collective strength to influence the practices of the insurance industry or to consider organizing our own internal insurance mechanism as a counterweight.

Third, Congressional leaders could use their influence they have to move the insurance industry to meet the special needs of the motor coach industry and travel tourism through voluntary steps, perhaps through a special pooling arrangement. There is precedent for this in the aviation field.

Fourth, the Congress should consider the adoption of reasonable legislation which would put a cap on liability. the current expansion of the definition of liability by judges and large awards by juries are major causes of the problem.

Thank you, Mr. Chairman.

[The statement follows:]

STATEMENT OF NORMAN R. SHERLOCK, PRESIDENT, AMERICAN BUS ASSOCIATION

We appreciate this opportunity to testify on behalf of our 3,500 members. They run the gamut of businesses who are engaged in travel and tourism—ranging from motorcoach tour and charter operators to theme parks, sightseeing services, hotels, motels, restaurants and travel promotion entities. All of them are affected directly or indirectly by the insurance crisis that threatens to overwhelm the industry.

I want to thank you for taking the initiative to hold this hearing for it is critical that people who recognize the value of tourism focus on what this insurance problem means. We have all been optimistic and enthusiastic about tourism becoming the number one economic enterprise of this country shortly after the year 2000 but that rendezvous with destiny could be substantially delayed by the impact of today's insurance crisis.

The attention and influence of the Congress is essential in addressing this problem because it is nationwide in scope and is affecting every segment of business in America. It is not isolated to any state or region. In order for our problem to be resolved, the determination and imagination of congressional leaders must be brought to bear on it. This is not time for 'dynamic inaction' or a 'hands-off-policy' simply because the insurance industry is not federally regulated at this point. The congress has the power to take steps to alleviate the situation and to influence the insurance industry to act responsibly in its own interests.

Throughout the tourism industry, the insurance crush is being felt, as various companies are either unable to obtain coverage for liability, or can do so only by paying astronomical rates which drastically cuts into their financial resources. It affects the ability of many to make a profit and continue in business.

It is not clear that state governments can handle the problem. We have sought for help there but it may simply be too big for them. It is, after all, a national problem.

Anticipating the growing insurance crush, I wrote several months ago to the governors of all the states, asking them to focus on the problem and to take whatever action they could to provide relief to motorcoach operators, as well as the travel industry members of the association. The strongest action in this area has been taken by Governor Kean of New Jersey who issued an emergency order freezing premiums and prohibiting insurance companies from cancelling policies until appropriate regulations could be adopted by state insurance commissions.

The range of response to my letter ranged from those who said that they "are reviewing the matter very carefully", have blocked mid-term cancellations, have assigned risk pools which will take care of it, or have influenced the insurance companies to partially relieve the situation in regard to such things as day care centers and municipalities. But there is no solid indication that the states will be able to deal with the problem in a comprehensive manner that precludes widespread capricious underwriting practices and exorbitantly high rates. It does not promise to become any better in coming months and it is possible that the seething resentment that is running strongly throughout the states now may erupt into a red-hot political issue that will force political figures at the national level to take strong measures.

The scope of our dilemma can be seen in the example of various segments of the Association and the travel/tourism industry.

One motorcoach tour operator who paid $120,000 a year ago for coverage now has to pay $775,000.

A theme park that paid $100,000 on its insurance in 1985 will pay $665,000 next year.

A 205 room hotel that paid $38,000 must now pay $100,000.

A snowmobile rental operator with 600 units in Yellowstone could not get coverage, as of last week.

These are typical of what's happening. The results are predictable. At the least, the prices of tourism services will go up where companies can adjust their rates. Where businesses can raise rates without pricing themselves out of the market they will be forced to do so. But that is not an option that is open to everyone. The hotel will have to realize a 3% increase in business just to stay even. The motorcoach operator is caught in a vise. He doesn't make enough profits to offset this cost and can't raise his rates due to competition, so the answer is to reduce service and try to sell half his fleet to stay alive. Some won't be able to stay in business at all, as was the case with Shubat Bus Company.

The resentment of our members wouldn't run so high if the insurance companies' action had not been so sudden or drastic—or if we felt that we were paying our fair share. However, there appears to be little correlation between the records or quality of our members and the astronomical rates that are being exacted. It is our view

that the operators and the travel/tourism industry are bearing a disproportionate share of the burden for the insurance companies problem. We do not believe that the insurance industry has singled us out, but it seems evident that we and others are, in effect, being forced to pay for its past bad judgment.

Last year was the worst year for insurance company losses in history but one must consider how they got into this situation. Even though it's not entirely their fault, a good portion of it is. South Carolina's chief insurance commissioner explained the dynamics very well in an article in the Greenville News.

"During the period when inflation was running rampant and interest rates were at an all time high, many insurers throughout the United States were forced, or chose, to write as much insurance business as possbile to collect as many premium dollars as they could, in order to gain the advantage of the high investment yields prevalent at the time.

"Many insurers in our state who write commerical property and casualty coverages for our business community intentionally underpriced their insurance products in order to beat their competitors to these investment dollars. They gained this business advantage by offering authorized credits and premium discounts on certain risks which should have been charged higher rates, and in doing so ignored underwriting losses which were then more than offfset by investment gains.

"The irony of this practice is that many consumers, be they small businesses or large corporate enterprises, were gaining the benefits of insurance protection at a lower than normal price, while at the same time, some insurers were laying the groundwork for losses which would eventually devastate their financial posture.

"As our state and nation rose from the depths of the recession, inflation dropped, interest rates dropped and for most businesses, the boom was on.

Unfortunately, the insurance industry found itself saddled with large amounts of business placed on its books at an inadequate premium level. When underwriting losses could no longer be offset by investment income, the commerical property and casualty insurance industry found itself in the position of a bottom line net loss for the first time in decades."—(John G. Richards V, "The Greenville News," July 7, 1985)

One of my insurance broker members explained it in the following manner:

"We came out of a moderate market crunch and high rate climate in 1977–79 to find outselves in an industry, insurance, where many companies had been taken over by *financial type mangers* as opposed to the traditional underwriters. They introduced a new concept, "Cash-flow", meaning that they told the underwriters, "damn the torpedos and underwriting, full speed ahead towards generating cash. We'll invest it and get the kind of return that will offset any potential underwriting losses you might have."

"This was prompted by the 18–20 percent interest rates that were on the horizon in 1980. The results? A competitive rate cycle, the likes of which has no historic parallel, cash-deferred payment plans, and many marginal insurance carriers coming into the business.

"The results were that we saw a depressed rate climate *enjoyed by buyers and* brokers/agents, although the latter did suffer significant reductions in income as the commissions were generated on significantly reduced premiums, and a buyers climate that was exceedingly attractive."

What happened?

"The rates were too low, the interest rates dropped, the financial stability of many reinsurers was shaken, and *losses soared.* The losses were these that might have ben expected and perhaps could have been carried by proper underwriting."

At the same time, the insurance companies are not alone at fault, for the problem arises from our judicial system as well. As long as there is no sensible limit to litigation by everyone while judges keep expanding the definition of liability and juries produce astronomically high awards, the problem will not be resolved. The whole issue of the judical framwork of this country needs to be addressed.

Given this background, what can be done?

First, continue and intensify the congressional inquiries to determine the facts about what has brought about this situation and the degree to which these astronomical rates are warrented. The insurance industry needs to know that it is being focused on by the greatest law-making body of the land. Congress should give careful consideration to regulating insurance companies in some way, in order to curtail abuses. Insurance companies should be made acutely aware that, if they are going to engage in almost absolute no-risk, guaranteed high profit activity, that will be balanced by some accountability in order to protect the public. That is essential, particularly for small companies who do not have the financial resources or strength to withstand the onslaught of exorbitant rates.

Second, the transportation and travel/tourism industry need to do everything possible to help themselves. Certainly, some companies can increase their deductible level and reduce premiums somewhat. The large ones can self-insure.

These individual measures, however, will not resolve the broad problem and the industry needs to consider ways to develop, focus and maximize its collective strengh to influence the practices of the insurance industry, or to consider organizing its own insurance mechanism which could provide for availability and moderation of rates. To that end, we believe that this subcommmittee and other congressional leaders who are interested in tourism could help arrange a summit conference of all segments of the industry to consider steps that it might take to deal with the insurance crisis and ameliorate rates.

Third, congressional leaders could use their influence to move the insurance industry to meet the special needs of the motorcoach industry and travel/tourism through voluntary steps; perhaps through a special 'pooling' arrangement. There is precedent for this.

In the early stages of aviation, the airlines faced a situation where they could not readily obtain insurance coverage. There was a need for high limits of coverage but the loss potential could not be handled by any one company. Consequently, national political figures met with CEO's of the insurance companies to obtain some relief, in lieu of federal legislation.

A voluntary 'pooling' plan was developed whereby the risks were parcelled out to various insurance companies, so that none would bear a disproportionate share of any loss, and it provided the needed coverage for the airlines. We suggest that the Congress and this subcommittee consider the feasibility of such action in relation to our current dilemma.

Fourth, the Congress should consider the adoption of legislation which would put a cap on liability. The constant expansion of the definition of liability by judges and large awards by juries are major causes of the problem.

It has been suggested that the contingency fee system that encourages lawyers to seek the highest possbile damages should be curtailed. That is not likely to happen and the better long-term solution may simply be to reform the laws and guidelines for our judicial system, so that victims of negligence receive compensation but punitive damages are not assessed.

In any event, we believe that the time has come to consider legislation to define liabilities and place a reasonable cap on them.

[The following information was subsequently received for the record:]

QUESTIONS OF SENATOR PRESSLER AND THE ANSWERS

Question. What types of suits are filed against bus operators? How frequently are you members sued?

Answer. The most typical suit filed against a bus operator is a personal injury action brought by a bus passenger claiming to have been injured in an accident involving the bus. There are no readily available figures concerning how often ABA members are sued, but we do have figures that show how often bus accidents, which give rise to suits, occur and the per bus annual claims cost for ABA members. In 1984, the accident rate for intercity buses was 4.24 accidents per million vehicle miles. This was essentially the same rate as that in 1982 and 1983. A survey of ABA members indicated that in 1984, the claims loss per bus was $2,283, which again was consistent with the loss numbers in 1982 and 1983. By comparison, insurance costs for those carriers almost tripled during that 3 year period from $2,100 per bus to $6,000 per bus. Today, that per bus cost is generally over $10,000.

Question. What types of risk management initiatives could bus operators adopt to make their firms more attractive to insurers? Has the ABA developed any risk management guidelines for their members to follow?

Answer. In the intercity bus industry, risk management means safety. Most established bus carriers have extensive safety training and awareness programs for their employees, particularly their drivers. These programs should make these companies more attractive to insurers; however, as the figures above indicate, insurance premiums today bear little relationship to accident frequency and claims costs, both of which are impacted directly by the quality of an operator's safety program.

ABA has developed an extensive risk management, or safety awareness, program for its members. We believe this program is particularly helpful to the many new bus operators that have entered the field since deregulation. The main components of this program are:

1. Development of training materials such as slide shows and driver training aids, for the use of the members.

2. Regional safety seminars held periodically around the country covering all safety related items from compliance with federal safety regulations to safe driving tips to the latest on insurance.

3. Regularly published Safety-Gram, which covers all aspects of employee hiring and training and on-going evaluation programs and contains letters to drivers on specific safe driving subjects. A recently started new magazine called The Bus Operator, which contains detailed articles on proper bus operation and maintenance.

4. A new membership requirement that all ABA members must participate in the ABA Safety Awareness Program, as described above.

Question. What specific regulatory or statutory steps, if any, should the Federal Government take in resolving the insurance problem?

Answer. There are numerous steps that could be taken by various parts of the Federal Government to ease the insurance crisis for bus operators, and ABA is actively urging that these actions be taken. They include:

1. ICC approval of limited self-insurance by bus carriers. ABA has filed an application to allow qualified bus carriers to self-insure for up to the first $5 million of insurance with adequate excess insurance above that level. This would enable qualified bus carriers to reduce their insurance costs substantially, while continuing to provide full protection to the public.

2. Effective enforcement by ICC and DOT of existing insurance requirements so that all bus carriers are playing on a level playing field. ABA has petitioned the ICC to require all bus carriers to file with it specific evidence of compliance with the new insurance minimum standards. No such specific evidence is now required. ABA has filed with DOT a petition asking that all bus carriers be required to carry a copy of such evidence in their buses. At present, there is no such requirement so DOT is not able to enforce the statutory standards through their road checks and related inspections, particularly as to uncertificated bus carriers that do not have their offices visited regularly.

3. Congress should adopt legislation making the Bus Regulatory Reform Act's insurance minimums clearly applicable to all commercial motor vehicles carrying passengers and confirming that uncertificated carriers are to carry certificates of insurance in their vehicles at all times. Such legislation would make it clear that "not for hire" passenger motor vehicles operated by churches or social groups, which are now covered by the federal safety requirements contained in the Motor Carrier Safety Act, must also comply with federal insurance minimums. Furthermore, it would provide a mechanism for monitoring compliance.

4. Congress should explore legislative remedies that would limit bus carriers' liability in such a way to bring insurance rates back down to a reasonable level for interstate bus carriers. This should include appropriate limits for bus carrier bodily injury liability that are sufficiently high that the injured are properly compensated but provide a reasonable liability cap so that insurance companies can more precisely assess the risk in interstate bus operations and thus not impose premiums based on the uncertainty of open ended exposure.

Senator ROCKEFELLER. Thank you, Mr. Sherlock.

Senator Gore has come in. Senator Gore, would you care to make a comment?

Senator GORE. I am catching up on the testimony by reading it. I apologize to this panel and to others for not being present earlier, but the Government Affairs Committee had a hearing which I was deeply involved in and it prevented me from being here.

In light of that fact, I would prefer to have you just go on and I will save any questions that I have until later.

Senator ROCKEFELLER. Thank you very much.

Ms. Canter.

Ms. CANTER. Good afternoon, Mr. Chairman and members of the subcommittee.

My name is Louise Canter and I am a vice president of Patterson and Associates Insurance Agency in Falls Church, VA. I am here today representing the Independent Insurance Agents of America, a national trade association which represents approximately 220,000 agents and their employees across the country.

Pick up almost any newspaper today and the dimensions of the unprecedented strain on insurance availability become clear. Insurance coverage for everything from pollution liability to commercial space launches to truck transport to daycare centers cannot either be purchased at all or, if coverage is available, premiums are beyond the financial grasp of most customers in need.

At the same time, we read of one or more examinations coming up of the availability issue, a Congressional hearing here, an agency or a departmental study there. It is a combination to either be welcomed or feared, depending on the understanding of the unique nature of the insurance industry.

It is to help your subcommittee and other members of Congress better understand the issue, Mr. Chairman, that I testify today. I also hope to bring to the subcommittee's attention the perspective of an independent agent on the availability issue.

As independent agents, we wear two hats, one being a member of the insurance industry representing our companies and the other as agents for our clients, the consumers. My job as an agent is to find the coverages my clients need to stay in business and to help them to find a way out of the availability crisis.

I would like to offer a few general observations on insurance availability, some suggestions on how to improve it, and then answer any questions you may have. To understand availability, it helps to understand insurance, what it is, how it works, how it is regulated. Wide swings in availability and in the industry's overall capacity to insure certain risks are common features of the industry's economic landscape.

We are all familiar with the unique nature of insurance. Companies assess risks, predict future losses, and reserve against those losses, and these components rely on contractual certainty, economic stability, and the law of large numbers.

It is also useful to remind ourselves that insurers are in the business of risk-taking to make, not lose, money. As a highly competitive and until recently profitable business, one should not begrudge the insurance industry the business decisions and marketing judgments necessary to ensure profitability.

To a large degree, the decisions now being made and the strain on availability and affordability now being felt reflect forces beyond the industry's control, and they have been profoundly destabilizing. In effect, contractual obligations have been rendered uncertain by the courts. There has been a dramatic decrease in the interest rates over the past 5 years, resulting in a severe loss in planned investment income.

And in some specialty lines now in the news, there have been huge losses simply beyond the capacity of the industry to absorb. This is because the risk cannot yet be spread widely enough in some cases, such as in satellite insurance, or because mandated liability limits soak up more insurance capacity than in the past, such as for truckers insurance. This trilogy of insurance industry problems—tort litigation, decrease of investment income, and record losses and settlement costs—tell a large part of the availability story.

Another part of the story of insurance availability is State regulation. Although a member in good standing of the free market, the insurance industry is already highly regulated. Depending upon the state, such choices as where and how to invest money, how to price a policy, and how much to reserve against losses and insolvency are scrutinized and sometimes constrained by regulation. In all states, insurance commissioners are charged with seeing to it that insurance pricing is not inadequate, excessive, or unfairly discriminatory.

An important point and something to keep in mind is that insurance regulators have the authority to protect the industry from itself and the public, from inadequate reserves and capacity should insurers price policies too low.

As an insurance agent, I have to say there is a third part to the story, the component of the availability and affordability of insurance. It is very much within the industry's power to control. Predominant as the tort, economic and loss components of the problem are—and one cannot ascribe equal value to these contributing factors I am describing here—it must also be said that something important has gone wrong with the way insurance companies plan, implement pricing and underwriting strategies, and anticipate market swings, which could be better accounted for.

The shifts in income and profitability natural to the industry, which are now exaggerated by forces beyond the industry's control, are at least aggravated by industry inability or unwillingness to chart for itself a more stable and economically sensible course. Severely competitive underpricing when times were good, followed by ill-conceived efforts to make up lost ground too quickly, have almost certainly made a very bad situation worse.

Another reaction by insurers to the availability crisis has been to treat all types of risk with the same bunker mentality. To be sure, steps must be taken to shore up reserves and protect against future unsustainable losses where the courts and laws have conspired to render risks uninsurable.

But not all risks have been similarly undermined, nor all underwriting made as unfathomable as the celebrated examples of pollution and professional liability. As my National Asociation's President, Mr. Richard Taylor, remarked on a panel just last week: "Underwriting is the science of trying to find out a way of writing a risk, not trying to find a way to get out of writing it."

It seems that now the underwriters are trying to find in most cases a way to get out of writing a new piece of business, excluding the pockets. He said: "There are still many companies out there who have got moratoriums out on perfectly good classes of profitable business and will not write it at any price."

Mr. Chairman, that briefly is the story as an independent agent would tell it: an industry unique in function and cyclical in nature which has experienced an unusually damaging combination of tort trends, economic deflation, and record losses. Given these observations, what can be done to restore availability and affordability to insurance markets? And I will just summarize, if I can, some steps that we have outlined.

What to do? First off, reassess and reform tort law. Second, strengthen State regulation. Third, promote alternative marketing plans. Fourth, promote inter-industry task forces. Fifth, consider the new ISO policy forms.

And what not to do? First, do not Federally regulate insurance. Second, do not establish Federal insurance programs. And third, do not mandate insurance coverages or liability limits.

Mr. Chairman, that concludes my remarks. I would be happy to answer any questions that you may have. And I hope I have provided some information that will help the subcommittee understand the availability crisis.

Thank you.

[The statement follows:]

STATEMENT OF LOUISE C. CANTER ON BEHALF OF THE INDEPENDENT INSURANCE AGENTS OF AMERICA, INC.

Good morning Mr. Chairman and members of the subcommittee. My name is Louise Canter and I am Vice President of Patterson and Associates Insurance Agency in Falls Church, Virginia. I am here today representing the Independent Insurance Agents of America, Inc. (IIAA), a national trade association which represents approximately 220,000 agents and their employees across the country.

Pick up almost any newspaper today and the dimensions of the unprecedented strain on insurance availability become clear: insurance protection for everything from environmental risks to commercial space launches to truck transport to day care and beyond, it seems either cannot be purchased at all, or, when available, exceeds the financial grasp of most customers in need. With almost equal frequency, we read of one or another new examination of the availability issue: a congressional hearing here, an agency or department study there—it is a combination (perceived market crisis, federal government scrutiny) to be either welcomed or feared depending upon the understanding of the issue and the recommendations made.

It is to help your subcommittee and other members of congress better understand the issue, Mr. Chairman, that I testify today. I also hope to bring to the subcommittee's attention the distinctive perspective on the availability issue of the independent insurance agent: simultaneously a member of the insurance industry and a consumer representative, leading the search party both for the coverages his customers need to stay in business and for a path out of the availability crisis. To do this, I'd like to offer a few general observations on insurance availability, some suggestions on how to improve it, and then answer any questions you may have.

WHY IS THERE AN AVAILABILITY CRISIS?

To understand availability, it helps first to understand insurance: what it is, how it works, how it is regulated. In many important respects, swings in insurance availability and in the industry's overall capacity to insure certain risks are common features of the industry's economic landscape. We're all familiar with the unique nature of insurance—assessing risk, predicting future losses, reserving against those losses—and how heavily these components of the business of insurance rely on contractual certainty, economic stability, and the law of large numbers. It is also useful to remind ourselves that insurers are in the business of risk taking to make, not to lose money. As a highly competitive, and, until recently, profitable business, no one should begrudge the industry the business decisions and marketing judgements necessary to ensure profitability.

To a large degree, the decisions now being made, and the consequent strain on availability and affordability now being felt, reflect forces beyond the industry's control and profondly destablizing in effect: contractual obligations rendered uncertain by the courts (tort liability), a dramatic decrease in interest rates over the past five years (investment income), and, in some specialty lines now in the news, huge losses it is simply beyong the capacity of the industry to absorb, either because risk can't yet be spread widely enough (satellite insurance) or because mandated liability limits soak up more capacity than would otherwie be the case (truck insurance). This triology of insurance industry problems—tort litigaiton, invesment income, and record losses and settlment costs—tell a large part of the availability story.

State regulation

Another part of the story of insurance availability is state regulation. Although a member in good standing of the free market, competitive economy, the insurance industry, it should always be remembered, is highly regulated.

Depending upon the state, such otherwise free choices as where and how to invest money, how to price a product, and how much to reserve against losses and insolvency, are at least scrutinized and sometimes constrained by regulation. In all states, regulators are charged with seeing to it that insurance pricing is not inadequate (a floor), excessive (a ceiling), or unfarily discriminatory (a must). Thus there resides within insurance regulators the authority to protect the industry from itself and the public from inadequate reserves and capacity should insurers price products too *low*. An important point, and something to keep in mind when tracing the causes of the current crisis, and searching for ways to avoid the next.

Insurance company behavior

Finally, as an insurance agent, I'd have to say there is a third part to this story, a component of the availability and affordability of insurance it is very much within the industry's power to control

Predominant as the tort, economic, and loss components of the problem are—and one cannot ascribe equale value to the contributing factors I'm describing here—it must also be said that something important has gone wrong with the way insurance companies plan and implement pricing and underwriting strategies, and anticipate market swings which could be better accounted for. The shifts in income and profitability natural to the industry and now exaggerated by forces beyond the industry's control, are at least aggravated by industry inability or unwillingness to chart for itself a more stable, economically sensible course and stick to it over time. Product underpricing when times were good followed by ill-conceived efforts to make up lost ground too quickly, almost certainly have made a bad situation worse.

Another largely controllable reaction to the real availability crisis in lines of insurance such as environmental liability, which will not be easily or quickly resuscitated without major legal reform and painful economic adjustments, has been to treat less obviously troubled risks with the same (understandable) bunker mentality. To be sure, steps must be taken to shore up reserves and protect against future, unsustainable losses where the courts and laws have conspired to render risks uninsurable. But not all risks have been similarly undermined, nor all underwriting made as unfathomable as the celebrated examples of pollution and professional (medical) liability. As my national association's president, Mr. Richard Taylor remarked on a panel just last month, "Underwriting is the science of trying to find out a way of writing a risk; not trying to find a way to get out of writing it. It seems that now the underwriters are trying to find in most cases a way to get out of writing a new piece of business." "Excluding the pockets," he said, "there are still many companies out there who have got moratoriums out on perfectly good classes of profitable business and will not write it at any price."

Mr. Chairman, that, briefly, is the stroy as an insurance agent would tell it: an industry unique in function and cyclical in nature, an unusually damaging combination of tort trends, economic deflation, and record losses leading in the mid-1980's to a down cycle of unprecedented proportions, and a model of market behavior and planning within the industry much in need of reform. Given these observations, what can be done to restore availability and affordability to insurance markets?

WHAT TO DO

(1) *Reassess and reform tort law.* No issue is more fundamental to the current insurance crisis, nor more troublesome to the public's sense of fairness and reason, than the explosion in this country of litigation, court decree, liability assessment, jury awards, and settlement costs now associated with our tort system. This is not, I hasten to add, a problem necessarily congress's to solve: several and growing numbers of state legislatures are adopting tort reforms which may help nudge tort trends in a less damaging direction.

(2) *Strengthen state regulation.* As mentioned earlier in my remarks, state regulators have the authority and competence to address many of the quirks in industry behavior (underpricing, overbroad application of defensive strategies to risks not seriously affected). These regulators should be supported by agent and industry groups in their states, and encouraged to design and implement regulations to help alleviate the availability crunch.

(3) *Alternative marketing plans.* Where lines of insurance become unavailable or unaffordable in conventional markets, alternative markets should be established—again, state-by-state, and, where possible, by voluntary participation. In California, for example, a market assistance plan run by the independent insurance agents state association in cooperation with insurers and affected industries finds coverage at an affordable price for day care centers. Insurance carriers in the state volunteer to review and underwrite proposals funnelled to them through the agents' association. Similar plans are being tried in Oklahoma for liquor liability risks, and in Maryland also for day care coverage.

Where voluntary market assistance plans prove unfeasible, state regulators can mandate joint underwriting associations, requiring a group of carriers to underwrite and service certain risks, and then dividing the cost among all other carriers which operate in the state. IIAA's preference, however, is for voluntary plans.

(4) *Inter-industry task forces.* Emphasizing voluntary, market solutions to availability is always to be preferred, and affected industries at the local, state, and national leve' should be organized and encouraged to get together with each other and

with insurance agents and companies to assess markets and offer proposals for increasing availability and reducing price.

(5) *New ISO policy forms.* The insurance industry's national rating bureau and policy designer, the Insurance Services Office, is introducing two new policy forms for universal industry use. Without getting too technical, the new policy forms are designed to enchance insurability and reduce claims and settlement costs in a way consistent with insurance industry needs and customer protection. Although IIAA does not endorse every proposal contained in the new policy forms, all parties should encourage implementation and await the results of the new ISO form in the market.

WHAT NOT TO DO

The temptation for federal intervention will be strong, but based on past experience and on the possibility of making worse by federal interference the distortions now plaguing liability markets, it should be strongly resisted.

(1) *Do not federally regulate insurance.* Calls for federal regulation of insurance are a staple of self-styled consumerists and economic theoreticians who never met a federal program they didn't like. Proponents of federal regulation are less concerned with insurance availability then they are with the allocation of insurance funds in ways they deem socially or politically desirable. By imposing additional costs, contraints, inefficiencies, and market distortionis, federal regulation could be expected to make matters worse. State regulation is fully up to the task of regulating for solvency, availability, and affordability in the context of separate, variegated proposals which can be modified or abandoned without effectng the entire industry.

(2) *Do not establish federal insurance programs.* While on the surface federal reinsurance or direct insurance for coverages otherwise unavailable seems plausible, experience has shown federal insurance programs don't deliver. Federal crime, flood, crops and nuclear insurance programs—to name only the most visible examples—consistently lose money, are plagued by operating and servicing inefficiencies, and usually end up serving political rather than economic or market objectives.

(3) *Do not mandate insurance coverage or liability limits.* Hard as insurance availability is to live with, there are usually market reasons to account for the crunch. Government has never been good at repealing the laws of economics, and to the extent coverage is mandated it will be at taxpayer expense (since the market has already determined it cannot be provided for a profit). Similarly, mandated liability limits where insurance is otherwise available (Motor Carrier Act limits for example) inject exactly the kinds of market distortion and increased prices that quickly dry up whatever coverage might have been purchased. Truck insurance for example, is not today unavailable, it simply be afforded at the artifically high liability limits the Motor Carrier Act has imposed.

Mr. Chairman, that concludes my remarks. I would be happy to answer your questions and hope that information. I've provided will help your subcommittee understand the availability crisis. Thank you.

[The following information was subsequently received for the record:]

QUESTIONS OF SENATOR PRESSLER AND THE ANSWERS

Question. What efforts have the independent insurance agents made to encourage the insurance companies to practice sound underwriting practices?

Answer. As a national trade association, we persistently encourage our insurance companies to price and underwrite risks carefully, in accordance with a long-term market strategy, and to resist over-reacting to the economic cycles which naturally plague the insurance industry. As insurance agents, our members provide companies the market data they need to underwrite carefully, and clients the advice and counselling necessary to reduce losses. Urging sound underwriting practices, and seeking to avoid the kind of market dislocation we are now experiencing, are an integral part of our association's commitment to public and member interests.

Question. What specific regulatory and statutory steps should the Federal Government take in resolving the insurance problem?

Answer. In general, the federal government has, and should have no direct role in insurance regulation. This should not be considered simply a predictable insurance industry response, but assessed on the basis of the results of federal intervention where it has been tried before. Where the federal government has offered insurance directly (flood, crime, riot, crop), the results have been costly and inefficient. Where it has mandated liability limits or created new exposures (trucking, pollution liabil-

ity) the results have been to intensify market distortions. And where it has attempted, thus far unsuccessfully, to impose national standards of coverage (health and auto no-fault), the prospect of raising to a universal level the potentially high costs and market dislocations which might otherwise be limited by experimentation in the states has been enough tot dissuade past congresses.

There are two areas, however, which may require or benefit from a federal approach. The first is federal product liability tort reform, probably necessary to account for the flow of products in interstate commerce. The second is amendments to the federal Superfund law (CERCLA) to permit the restoration of now unavailable pollution coverages by eliminating retro-active liability for risks never contemplated in pre-CERCLA insurance contracts, and by modifying the joint and several liability now imposed under CERCLA. Beyond that, at the federal level, the best action is no action.

Question. Do the independent agents feel that State regulators have the resources to adequately police the insurance industry? What additional steps could the agents take to strengthen the insurance commissioners' regulatory authority?

Answer. State insurance department resources will of course vary, but in general insurance department budgets should be expanded, staffing levels increased, and funds for solvency dedicated exclusively for solvency protection. IIAA nationally, and many of our state associations, support and work for these objectives in state legislatures.

As for commissioners' authority, they have the authority now to regulate rates (which may be neither inadequate, excessive, nor unfairly discriminatory), and a variety of insurance holding company activities. In several important ways, state regulatory authority, if effectively asserted, could help address many of the immediate market problems associated with the long-term liability crisis: regulation for solvency (rating too low), regulation for competition (rating too high), guidelines for mid-term permium increases, non-renewals, or cancallation. Insurance agent state associations in many states support these and other specific regulatory proposals, and IIAA nationally has called for more effective state regulation to address many of these issues.

Question. What types of tort reforms do the independent agents support?

Answer. At the federal level, product liability tort reform as contained in the Kasten bill, S. 100. In the states, three kinds of tort reform would be the most helpful in retoring insurance markets: caps on attorney fees, elimination or modification of punitive damage awards, and modification of joint and several liability. In discussing tort reform, IIAA would emphasize that while tort reform is essential to returning certain kinds of risks to insurability, tort reform is not only an insurance issue. The tort system in this country needs reform quite apart from the direct effect such changes would have on insurance markets.

Question. What types of regulations do you feel the State commissioners should adopt to help alleviate the availability crunch?

Answer. State insurance departments can help agents and clients place and find insurance through voluntary market assistance plans (MAPs); help insurance companies stay in business by regulating for solvency; help agents and their clients secure replacement coverage by requiring advance notice of mid-term cancellations, premium increases, or non-renewals, and by establishing guidelines within which such mid-term or renewal decisions must be made.

Question. Many of the groups which oppose ISO's new commercial general liability policy are concerned that introduction of this "claims made" form will mean the end of the "occurrence" policy. Do you agree with that assessment? Do you expect that agents will be willing to recommend an "occurrence" policy instead of a "claims made" policy to a customer?

Answer. There will always be a market for the occurrence policy among the types of risk that do not have so-called "long-tail" exposure—the potential for injury and claims many years after exposure occurs. And if the current insurance market should improve, occurrence policies now being abandoned in favor of claims-made may be revived as a competitive tool to attract new business. The claims-made policy is designed to restore the insurability of risks now diffuclt to insure because of latent exposure and claims, and the uncertainty of court interpretation of existing contracts. Under a claims-made policy, an insurer is responsible only for injury and claims which occur during the life of the policy—usually one-year renewable contracts. By renewing the claims-made policy each year, the insured is fully covered over time. If there is a period of exposure which falls outside the claims-made contract, retroactive coverage may be purchased separately to fill the gap.

The survival of the occurrence policy will depend on the acceptance and implementation of claims-made by state regulators, insurance companies, and agent

groups. Right now, reviewers are still mixed, and for the next several months the market will continue to see both claims-made and occurrence policies. Agents typically would advise whichever policy—claims-made or occurrence—makes sense for a particular risk.

Question. You have discussed a number of potential short-term and long-term solutions to the current insurance "crisis." As you are well aware, however, there are still a number of insurance buyers who cannot secure adequate and affordable insurance. Is there nothing the Federal or individual State governments can or should do to ensure that those buyers find insurance?

Answer. As discussed earlier in these responses, the federal and state governments can and should pursue civil justice tort reform, and state regulators can and should exercise existing regulatory authority to help alleviate current market conditions. In at least one specific area, the federal government could consider direct federal insurance or reinsurance support if it is willing to make the statutory changes necessary to restoring a private market: pollution liability. Such a program would of course expose the federal government to enormous potential costs (a conclusion the private market has already reached), and a public policy decision to subsidize those costs would need to be made (as in the federal flood insurance program). Other difficulties would arise, as with any federal insurance program, including the danger of mandated private carrier participation to spread the costs of a federal program. Still, the unavailability of pollution coverage in the private market, coupled with Congress's apparent unwillingness to remove the statutory impediments to environmental insurability, make a serious discussion of federal pollution insurance (or reinsurance) persuasive.

Senator ROCKEFELLER. Thank you, Ms. Canter.

Mr. Heydinger.

Mr. HEYDINGER. Mr. Chairman and members of the committee:

I thank you for this opportunity to share a few comments regarding a risk manager's view of the current and developing commercial property and casualty insurance marketplace. I am Dick Heydinger, risk management director for Hallmark Cards, Inc., and also a member of the executive committee of the Risk and Insurance Management Society, commonly referred to as RIMS.

RIMS is a non-profit association for risk and insurance managers of commercial and industrial enterprises, public entities, and service organizations. Our 3,800 organizational members represented in over 76 chapters throughout the U.S. and Canada include not only 92 percent of the Fortune 500 list, but also many smaller businesses, towns, and service organizations as well.

You do have my complete written testimony, so I just want to take a few minutes to highlight its contents regarding the availability and affordability crisis. The property casualty insurance marketplace can best be described as chaotic. By that I mean I have no knowledge of any commercial business, whether large or small, that is exempt from cancellation and non-renewal notices; two, insufficient limits for protection for replacement of expiring programs; three, premium increases which are often multiples of expiring rates; and four, renewal underwriting terms being offered which are often grossly inadequate to transfer risk, leaving policyholders with exposures that were commonly shifted to the professional risk-bearers, the insurance companies.

I was asked to provide examples in my testimony. There is the real life example of the hard market impact on Hallmark Cards, which I hasten to mention is a firm which does not have this long-tail latent liability exposure that we have heard so much about earlier this morning. This particular example given cites our excess general liability program.

In 1984, we bought broad coverage with limits of $500 million at a cost which averaged under $1,000 per million. For 1985, we could only buy half the limits, $250 million, at twice the cost. For January 1, 1986, it appears we will only be able to buy $75 to $100 million in limits at four times our 1984 cost. So limits will be 20 percent of '84 and coverage will be much more restricted.

I also broadened the example to include a third quarter 1985 excess liability renewal survey conducted in November by a national insurance broker, surveying 43 programs of a wide range of clients. The findings indicated 1985 limits were only 41 percent of 1984 limits. The average cost per million dollars of limits had risen sharply, 805 percent, from $2,570 per million in 1984 to $23,260 per million in 1985.

Just briefly, the impact of this hard market on concerns like Hallmark and others of our RIMS membership. First, we have the real concern that inadequate insurance exists to prudently operate our businesses, properly protect our growing asset bases, and offer ample security to our shareholders.

Secondly, many of our suppliers and vendors of materials and services cannot buy adequate insurance or afford to self-assume underinsured losses. Because Hallmark and RIMS members are often the party best able to pay, the companies are seriously exposed by others' acts.

Third, we must absorb these large premium increases, with serious implications in the competitive marketplaces we deal in. And additionally, RIMS members are reporting increasing concern for the potential of uncompensated victims as the coverage gap widens; and increased discussion of firms being forced to forego promising research projects or expansion plans in areas of high risk potential.

On causes, we briefly dealt with the two most commonly mentioned causes in the current marketplace problem: number one, cash flow underwriting, this idea of accepting any risk at insufficient rates just to obtain premium dollars for investment. We are quite honestly and frankly critical of the insurance industry for failure to better manage its affairs and reduce the severity of the wide cycles that plague the property and casualty industry.

We believe the industry could do much to improve its State by returning to basic risk selection and pricing techniques and by writing more carefully-worded policies, thus reducing misinterpretation by the courts.

And a second solution mentioned with great enthusiasm by the insurance industry is tort reform. Well, here we are totally sympathetic with the insurers' views and also believe the time for overhaul of our civil justice system has arrived.

Our greatest anxiety, however, on this subject, however, comes from the recognition that meaningful reform will not occur in the short-term. In the interim, insurers will not or cannot offer past levels of protection at the very time it is most needed by American business.

As far as potential solutions, our testimony offered some suggestions and other ways in which the Federal Government could assist. First, I would speak to the Insurance Service office's new claims made policy form. Our feeling is that it should be rejected by all the states. This CGL policy is the foundation of all commercial liability insurance in the U.S. The proposed form creates the likelihood of uncompensated policyholders and claimants and restricts the free movement to alternate carriers.

This subcommittee could do a valuable service to its constituents by voicing concerns on the matter to your representative State regulators.

Second, Congress should reject the proposed increase, hike in Federal excise tax on foreign reinsurance. Federal excise taxes are routinely paid directly by policyholders rather than insurers.

Third, serious consideration should be given to allowing the banking industry to add much-needed capital in the insurance field.

Fourth, Congress should consider expanding the concept of the risk retention groups which it has authorized for dealing with the products liability and the pollution liability shortages.

Lastly and perhaps most importantly, the current U.S. tax code has a tremendous bias towards the buying of commercial insurance. Premium payments are immediately tax deductible, whereas the commercial concern which chooses to self-insure these losses or has it imposed upon them through internal funding or captive insurance subsidiaries cannot deduct losses until they actually become payable.

In the 98th Congress, Representative William Frenzel introduced H.R. 2642, which would place insurance premiums and self-insurance costs on equal footing. This bill is even more important in the present setting, and we are hopeful and urge re-introduction.

On behalf of RIMS, I thank you for your time and attention.

[The statement follows:]

STATEMENT OF RICHARD HEYDINGER, VICE PRESIDENT, GOVERNMENTAL AFFAIRS, RIMS DIRECTOR, RISK MANAGEMENT, HALLMARK CARDS, INC.

Mr. Chairman and members of the committee I thank you for this opportunity to share a few comments regarding a risk manager's view of the current and developing commercial property and casualty insurance marketplace. I am Dick Heydinger, risk management director for Hallmark Cards, Inc., the world's largest manufacturer and distributor of social expression products, headquartered in Kansas City, MO. I am also a member of the executive committee of the Risk and Insurance Management Society (commonly referred to as RIMS) and serve as its current vice president-governmental affairs. RIMS is a nonprofit association for risk and insurance managers of commercial and industrial enterprises, public entities and service organizations. Our 3,800 organizational members, represented in over 76 chapters throughout the United States and Canada, include not only 97 percent of the Fortune 500 list but many smaller businesses, towns, and service organizations as well.

In the next few minutes, I would like to share some first-hand Hallmark experiences regarding the availability and affordability of property and casualty insurance and, pass along some brief reports received from other RIMS members on their firms' difficulties in developing proper risk transfer programs in today's environment. I would like to also suggest some possible short-term and long-term solutions that we at RIMS and Hallmark are exploring as possible means of relief.

AVAILABILITY/AFFORDABILITY

In all frankness, the commercial property/casualty marketplace can be described as chaotic. I do not know of any large commercial business that is exempt from cancellation and nonrenewal notices; insufficient available limits and markets for replacement of programs; premium increases that are often large multiples of expiring rates; and coverage that is grossly inadequate. Policyholders are left with a tremendous amount of uncertainty that just a few short months ago was readily transferred to the insurance mechanism.

The most discerning aspect of this situation appears to be that insurance availability is rapidly deteriorating. We apparently have not begun to reach bottom. Informal surveys of our members indicate that policyholders with casualty renewals in July and October were significantly better off than those trying to replace programs expiring December 1 or January 1. With the assistance of our insurance brokers, Hallmark keeps a running schedule of all casualty carriers potentially available for participation in our umbrella/excess liability program. Monthly, we have seen the number of likely carriers shrink and those that do remain, have added further underwriting restrictions.

To give you an example of the "hard market" impact on Hallmark, let me explain the liability umbrella/excess coverage program I just mentioned. As you can surmise from trips to your local Hallmark social expression store, Hallmark is not involved in a business with the long-tail, latent liability exposures that the insurance industry is so concerned with.

For the most part we self-insure our normal workday losses such as workers' compensation, automobile accidents, and slips, trips, and falls on Hallmark premises. We look to the professional liability insurer to provide coverage for the unpredictable, low-probability, but high-severity, type of exposures confronting all worldwide operations.

Two years ago, as we developed our 1984 liability program, we found a very responsive casualty marketplace. There were numerous insurers, offering broad terms and quite affordable rates. Approximately $800 million in limits were available to Hallmark. We were able to sort through the various insurers, and choose those that offered the highest quality financial security and had the best track records for willingness to pay losses. The result was a $500-million program, with highly rated carriers all using the same broad occurrence-based policies, at a total cost under $500,000.

One year ago, as we attempted to renew the program for 1985, we were quite alarmed to witness the early emergence of a new "hard market" cycle. By early March 1985, when we finally completed our January 1 renewal, we found that by combining all possible suppliers (many of whom had deteriorating financial statements and Best's ratings), we were able to buy only one half the limit, $250 million, at twice the cost and with numerous coverage restrictions. During the course of 1985, some of our program participants should have been replaced because their financial strength had been called into question or they issued cancellation notices. Attempts to do so, however, found no willing substitutes.

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Trying to renew our 1986 program has been painstakingly slow and has produced utter frustration. Although January 1 is just a few short workdays away, we presently have commitment for only $11 million.

It is our practice to closely monitor the capacity situation with our broker. At this point in time, our best estimate of availability, which has a tendency to decline each time it is reassessed, is that the conventional market will provide Hallmark between $75 and $100 million in limits, compared to $800 million in limits in 1984 costing four times less. To make matters worse, the coverage itself is severely reduced, excluding legal-defense costs and risks such as pollution.

And there have been other troubled lines of coverage for Hallmark. Attempts to renew our environmental liability program found only one willing seller. This seller offered one half the expiring limit at five times the expiring cost, and so restricted the coverage that it would not respond to claims outside our premises. We paid four times as much premium for one-half the directors and officers liability limits. Our first-party property insurance programs have also been affected. Costs are rising sharply as reinsurers retreat from locations with high-valued exposure and special-loss exposures such as flood or plastic-fire risks.

To broaden the perspective, I would like to share the results of a third-quarter excess liability renewal survey conducted in early November by a large national insurance broker, Marsh & McLennan, Inc. They asked their various U.S. offices to supply information on those large commercial clients which experienced excess liability renewals in the third quarter of 1985. The survey included 43 programs with participants representing a wide range of risks including manufacturers, financial institutions, retailers, contractors, utilities, conglomerates, and pharmaceuticals. The oil and energy industries were sparsely represented. The survey found 1985 limits to be only 41 percent of 1984 limits. The 1984 average cost per million dollars of coverage was $2,570 whereas the 1985 average cost per million had risen sharply to $23,260, an average increase percentage of 805 percent. This survey does not attempt to measure the reduction in protection represented by the more restrictive 1985 policy conditions. On summary, the availability/affordability problem is real and widespread. The list of problem coverage increases weekly, affecting entities of all sizes.

POTENTIAL IMPACT ON HALLMARK—AS AN EXAMPLE

To illustrate the concerns of large commercial business, I will site the overall impact of the "insurance crisis" on Hallmark.

First, there is a very real concern that inadequate levels of insurance are unavailable to operate our business prudently, protect our growing asset base and offer ample security to our stockholders. The inadequate limits offered by the conventional marketplace; the prospect that many carriers do not have the ability to pay large losses if called upon to do so; and the general unwillingness of insurers to accept difficult exposures such as pollution liability is simply unacceptable for our needs.

Second, we have many suppliers of materials and services—such as waste disposal firms, motor truck carriers, and plant physicians that are inadequately insured and many of which could not react responsibly to losses arising from their products and services. Each week, we are faced with doing business with more and more vendors whom we know have insufficient insurance to respond to potential claims. Because Hallmark is often the party "best able to pay" the company is seriously exposed.

Third, we are faced with absorbing precipitous premium increases and potential uninsured losses; which has serious implications in the competitive marketplace we deal. The high cost of insuring in America can only add another burden to the Nation's international trade problem.

Last, I would mention that as a direct failure of the conventional insurance industry, we have been required to devote extensive energy, management talent and scarce capital dollars to the development of nontraditional risk financing alternatives. We have joined with other American businesses in capitalizing a new insurance company designed to insure its investors' risks in developing other group risk sharing pools. We reluctantly enter the "insurance business" not because we think we can do better than the experts, but because they simply have left us no choice.

The other potential implications most mentioned by my peers in other fields are these. There is a growing concern that as businesses exposure-to-loss gap widens due to coverage and capacity curtailment, the potential of uncompensated American victims rises. And there is growing discussion of companies being forced to forego promising research projects or expansion plans in areas that represent high risk potential.

CAUSES

1. Cash-flow underwriting

The industry is quick to point its finger to external causes of its woes. We agree external factors are there, however, we also believe that the fundamental problem lies in the industry's failure to better manage its affairs and reduce the severity of the wide profit and loss cycles that plague the property/casualty industry in modern times. We think it was poor management which led to the cash-flow underwriting and market share mentality with its accompanying decline of underwriting skills. We believe the industry when it reports underwriting losses for the years 1982–84 that amounted to more than $34 billion, surpassing the total of all losses for the previous 25 years.

In fact, we are quite concerned whether the contingency reserves established by the industry are really sufficient to cover runoff liabilities or if in fact, they need to be further strengthened as the new round of price increases makes its way to the bottom line of the profit-and-loss statements. At this point we believe that the industry could do much to improve its state by returning to basic risk-selection and pricing techniques (bring those underwriters and actuaries out of the closet) and by devoting the time required to write carefully worded, artful policies to reduce misinterpretation by the courts.

2. Civil justice system

Another survival requirement mentioned with equal enthusiasm by the insurance industry is the need for reformation of this Nation's tort liability system. Many insurers today are doing much more than talking about this issue. Particularly foreign reinsurers, on which our American commercial insurance system is still heavily dependent, are choosing to sit on the sidelines and are waiting for the rules of the American tort system to change before being willing to re-enter the playing field. In this area, we are totally sympathetic with the insurer's views. Their problems are just a mirror reflection of our own as they accept our liability exposures for a price—the premium. We think the time for a major overhaul of our civil justice system is long overdue. Our greatest anxiety on this subject comes from the recognition that such change will not occur in the short term. In the interim we have an insurance industry which cannot or will not offer past levels of protection at the very time when our need for coverage is most needed.

Our very general and brief concept of priorities on tort reform are these: Reform should be broad-based and give equal protection to all industries, not just selected sectors such as the medical profession or products manufacturers. The high-frictional cost of the judical system and the surging legal costs are a tremendous waste. Judicial reforms must be made to allow the escalating amounts of litigation to be processed with greater efficiency and lower cost. The excesses encouraged by the contingency fee system must be curbed without causing unfair restriction to these sectors of society wishing to access our tort system. Realistic caps should be placed on noneconomic damages. Punitive damages should be shifted from the civil system to the criminal system where they can be more appropriately handled. Lastly, it is time for statutory replacement of some of our original theories of negligence that in recent times have been cast aside by a system designed to remedy societal problems regardless of the defendant's fault.

3. Effectiveness of state regulation

Many are taking this opportunity to designate inadequate state regulation as a major contributor to the reoccurring problem of the industry. For the most part, we find state regulatory personnel very capable, sincere and responsive to our members concerns. Many of these concerns are regional in nature and are best dealt with by a state mechanism. We do find, however, that most state regulatory bodies have a tremendous shortage of manpower and resources to carry out their critical functions. We have long been an advocate for returning a much larger share of the state insurance premium tax revenues (much of which we contribute as commercial consumers), to the State insurance department.

In the commercial area, regulation should focus on (1) the early detection of financial difficulties of individual companies, (2) enforcement of rules and laws against boycotts and other unfair trade practices and (3) the enforcement of minimum standards of competence and conduct by insurance companies, agents brokers and consultants.

SOLUTIONS

1. ISO's claims made CGL policy must be rejected by the States

Unfortunately, the insurance industry is attempting to atone for its cash-flow underwriting fling not only by increasing premiums, but also by drastically altering the quality of coverage offered to the policyholder. The Insurance Services Office (ISO) makes available rating, policy form, and related services for U.S. property/casualty insurers. ISO is introducing a claims made form which it is insisting that state regulators must approve for implementation by Janaury 1, 1986. The CGL is the foundation of all commercial liability insurance in the United States. The proposed claims mean CGL has the potential to create canyon size gaps in coverage for the commercial insured, raising the spectre of unindemnified claimants and policyholders alike. This claims means CGL also creates the tremendous likelihood that the policyholder will be locked into one insurance company, as the commercial insured may be forced into the position of having to pay up to 200 percent of its annual premium as a "severance fee" to the original insurer, if it is cancelled or desires to switch to another carrier. As time does not permit me to discuss the intricacies of policy coverage in detail, I am enclosing for the record RIMS testimony in opposition to the new form as well as the well reasoned rejection of the new form by the New York State Insurance Department. Of the greatest concern to consumers of insurance is that policyholders will be faced with the situation of having to accpet claims made coverage or nothing at all. Unfortunately, some 27 states have seen fit to approve without restrictions this one-sided policy form. Fortunately, many are reconsidering their approval. This subcommittee could do a tremendous service to their commercial policyholder constituencies by voicing your strong concerns about the claims made CGL to the insurance commissioners of your respective States.

2. Congress should reject a tax hike on reinsurance ceded aboard

RIMS understands that Treasury has proposed, and the Ways and Means Committee is considering, raising from 1 to 4 percent the excise tax on reinsurance ceded abroad. It must be understood that even before the current insurance capacity crunch U.S. property/casualty insurers reinsure much of the risks they assume abroad. The motivation for this hike seems to be the belief that the insurance industry does not pay its fair share of taxes. The legitimacy of this belief aside, be assured that, particularly in today's hard market, it will be the policyholder, and not the insurer or reinsurer who will shoulder the burden of this tax increase. This tax hike will exacerbate the rapidly escalating premiums forced upon the commercial insured in today's market.

3. Banks in insurance

ISO has projected a $62 billion shortfall in commercial insurance capacity over the next 5 years. The entry of banks into insurance should not be viewed as a short term fix to this capacity problem. There are many regulatory problems which must be resolved (for the record, a copy of the RIMS testimony before the New York State Temporary Commission on Banking, Insurance and Financial Services is enclosed). Unfortunately, the debate on both the federal and state level has seemed to focus on why banks should not be permitted to engage in insurance activities. RIMS respectfully submits that Congress and the states should now seriously consider what regulatory safeguards protecting market competitiveness, the banking consumer, and the insurance policyholder would be needed to permit a bank to lend much needed capacity to the insurance marketplace, by entry into the insurance field.

4. Congress should facilitate the formation of captive and risk retention groups

The purchase of insurance is but one means which the commercial insured has of effectively dealing with the risk of loss. If the insurer is large enough and/or has a stable loss history, he may seek to establish a loss reserve to fund predictable future losses. This may be a far more efficient alternative for the entity than the purchase of commercial insurance. Similarly, a commercial insured may establish an insurance company subsidiary which exclusively handles the risk of the corporate parent. This subsidiary is called a captive. The captive alternative gives the corporate parent the added benefit of allowing it to tap into the often less expensive reinsurance market, normally available to only primary insurers. Often more than one insured will form such a captive, called a risk retention group.

Unfortunately, conflicting state insurance laws often make it most difficult for insured or insureds with multi-state operations to utilize a captive. Recognizing this

problem, Congress several years ago passed the Risk Retention Act which facilitated captive formation for product liability risks. Recently a similar amendment was included in the Superfund Reauthorization Act passed by the Senate, which would facilitate captive formation to insure pollution liability risks which the insurance industry has excluded from coverage in its CGL policy. RIMS suggests that such legislation should be implemented on an across the board basis, and not just for pollution and product liability. We sincerely believe that captive formation can be facilitated without abridging legitimate state regulatory authority.

TAX EQUITY SHOULD BE AFFORDED ALTERNATIVE RISK FINANCING MECHANISMS

A self insured using a loss reserve or captive risk financing mechanism operates in a very similar fashion to a property casualty insurer. Both employ actuaries or qualified loss reserve specialists who determine how much revenue needs to be set aside to fund future losses. The Tax Code permits the insurer to deduct the amount which it sets aside in a loss reserve to pay future losses. That same privilege is not extended to the self insured who must purchase commercial insurance at often much greater expense, in order to receive the same tax treatment afforded to the insurer under the Tax Code. This subcommittee recognizes the importance of encouraging a stable financing mechanism through which an entity can protect itself against future loss and through which claimants can receive just compensation. Yet under our present system of taxation, the emphasis is placed on whether insurance is purchased rather than the quality of the funding mechanisms.

In the 98th Congress, Representative William Frenzel introduced H.R. 2642 which would permit a deduction for contributions made to certain self insurance loss reserves and for captive premium payments. Again in the interests of time, I am enclosing a copy of testimony which RIMS submitted to the Subcommittee on Oversight of the House Ways and Means Committee on this legislation. H.R. 2642 is even more important and timely in the present crisis and we hope to see the legislation reintroduced in the near future. The passage of this bill would provide the corporate insured the desperately needed flexibility to survive in this era of insurance unavailability.

On behalf of the RIMS membership and Hallmark, I thank you for your kind attention and the opportunity to share our views. If you have any questions, please ask. Thank you.

[The following information was subsequently received for the record:]

QUESTIONS OF SENATOR PRESSLER AND THE ANSWERS

Question. Has it been RIMS' experience that the drastic premium increases faced by businesses usually reflect past claims records?

Answer. Most of the past hard market cycles had a fairly close relationship to bad loss experience, poor investment results, or rapid shifts in social/economic exposures. The current hard market cycle, however, which has already created greater financial hardship on RIMS members than any preceding cycle of this century, does not seem to be based on past claims records. The most perplexing aspect is that we are probably 18 to 24 months away from the end of the crisis. Equally disconcerting is the fact that we find no industry classification or member company exempt from towering price increases and severe coverage restrictions. While some member firms have more serious problems than others, all members are scrambling for coverage and paying multiples of expiring premiums. Often, the very carrier who is declining to offer adequate protection to a member has never paid a claim for that member.

We point to the aviation liability industry as an illustration of how a classification of serious risk, if properly managed, can be successfully underwritten. The aviation liability underwriting community never engaged in the market-share, cash-flow underwriting practices of the general liability industry. 1985 was the worst year for aviation passenger deaths. In spite of this record-setting loss experience, coverage continues to be adequate and price increases remain reasonable. We accept this as an example of how underwriting professionals can sucessfully deal with difficult times.

The Insurance Industry reports that it has returned to a phase of true underwriting discipline. We disagree! During the extended period of market-share underwriting, the Industry underwrote everything—regardless of exposure or price. Now they are engaged in the opposite philosophy—they steer away from true risk. The Industry is content to limit offerings to only the most innocuous risk. We label this attitude the "herd instinct." If one company communicates some concern about a given

risk or class of risk—all underwriters turn tail and run. It is not true underwriting and it is not a professional or a responsible reaction to the purpose of their corporate existence—to bear risk for a fair and equitable price.

Question. To what extent are firms going out of business or not providing products or services because they cannot secure adequate or affordable insurance?

Answer. RIMS is currently conducting a survey of its entire membership and this is one of the key questions asked. We expect to be in a position to share the survey results with you around the first of March. Members are beginning to report that due to the lack of insurance, they are having to curtail activities and cancel associations with inadequately insured suppliers. We suspect that the effects of no insurance are just beginning to surface. With the passage of time and the materialization of uninsured claims, the situation could escalate. Until our survey results are in, we can only speculate on the timing and extent of this problem.

Question. Is insurance available to every business that wants it, assuming the business is willing to pay the necessary price? If it is not available, what can or should we do on the Federal level, in the short-term to ensure that every legitimate business is adequately covered at a "reasonable" price?

Answer. RIMS can equivocally respond that adequate insurance is not available, regardless of price, for its members' needs.

The Federal initiatives that could provide both short-term and long-term assistance are as follows:

Federal officials should use the influence of their offices to reject the widespread, indiscriminate usage of the Insurance Services Offices' claims-made Commercial General Liability Policy (CGL). The imposition of the ISO CGL claims-made form during the current chaotic market is collective, irresponsible behavior by the industry.

Congress should reject a tax hike on reinsurance ceded abroad. The current proposal calls for a rise in the F.E.T. from 1% to 4%. Policyholders should not be forced to bear this cost increase which is a direct pass through by the insurance industry.

Congress should facilitate the formation of captive-insurer and risk-retention groups by expanding the Risk Retention Act beyond the products liability field to all areas of third-party liability.

Tax equity should be given to alternate risk financing mechanisms. Employment of loss reserves or captive risk financing mechanisms should receive the same tax deduction treatment as insurance premium payments.

The U.S. Congress and state legislature should seriously consider the regulatory safeguards needed to permit banks to invest in the insurance underwriting business.

The U.S. tort liability system requires a major overhaul that can best occur at the Federal level. RIMS' priorities on tort reform are:

Reform should be broad-based and give equal protection to all industries.

Reforms must allow litigation to be processed with greater efficiency and at lower costs.

The excesses of the contingency fee system must be curbed without unfairly restricting access to the tort system.

Realistic caps should be placed on noneconomic damages.

Punitive damages should be shifted from the civil to the criminal system.

There should be statutory reinstatement of some of our original theories of negligence. Many of the original theories have been cast aside by a system designed to remedy societal problems regardless of fault.

Question. Could you discuss your specific objections to ISO's claims-made policy?

Answer. RIMS' major objections are stated below. Attached for the record is the complete RIMS position statement on the ISO CGL claims-made policy, as modified on January 15, 1986.

Unlike the old occurrence form the claims-made policy does not respond to the unknown and ureported claims tail. Unless the retroactive date remains the same or the policyholder is able to buy an unlimited discovery period significant potential for uninsured claims exist.

The claims-made format has for years been the principal policy used in the liability fields of Directors and Officers and Professional liability. These are the coverage lines with some of the greatest availability/affordability problems today. There are no examples of which we are aware, that would indicate that the claims-made form is a successful solution to the problems.

The new ISO forms do not deal with or resolve the vagaries of the present CGL coverage trigger. Many of the conditions that have led to inter-insurer or policyholder-carrier coverage disputes under the old CGL continue in the new forms.

Although ISO asserts that the claims-made form will not drive the occurrence format from the market—our membership is already observing a significant reduction in the freedom of choice and the indiscriminate use of claims-made on all risk classifications.

ISO's total exclusion of sudden and accidental pollution liability coverage is an unacceptable reaction to judicial misinterpretation of policy terms. The coverage is a critical element of the basic CGL form. ISO should redirect its efforts toward intelligent policy redrafting.

Senator ROCKEFELLER. Thank you, Mr. Heydinger. We appreciate your being here.

Mr. Chairman, Mr. Fritzel will be the final member of the panel.

Mr. FRITZEL. Thank you very much, Senator Rockefeller.

My name is Charles H. Fritzel and I am the assistant vice president for Government relations of the National Association of Independent Insurers, a voluntary trade association of over 500 property and casualty insurers.

Others have testified here today to the economic woes facing the insurance industry in 1984, as our worst year in history, with our combined loss ratio of 118, and I will not reiterate that long list again, but will say that in the last year the insurance industry has been able to overcome these types of problems.

Insurers have weathered inflation and recessions for decades without getting beaten up like we are in recent years. And while it is true that some companies, particularly those in the commercial lines, nearly perfected what one insurance executive described as kamikaze pricing, cash flow underwriting has been part of company operations since the 1950's, when the shift from property to long-tail liability coverage amassed large amounts of cash in dormant reserves that could be used for investments.

Something else is at work, and I think the numbers show it. After 6 months of rate increases, a stable securities market, and substantial investment gains, we still chalk up a disturbing operating loss of over $2 billion. Something is pulling insurers deeper under the water and it is holding them there, and that something else is the civil justice system.

We have all heard about the million dollar judgments and I do not think I need to bore you with more of those horror cases. For the companies that have to pay outrageous claims, the financial shock can be severe. But they are not really the problem for the industry as a whole. As is usually the way with big things, it is the small, little-noticed changes that over time produce the big effect.

What has happened to the civil justice system is what workers compensation lawyers call cumulative trauma. Federal civil filings are up 50 percent since 1979. State filings are up 20 percent since 1979. Last year there was one private civil suit for every 15 Americans. In Los Angeles alone, the cost for the average civil case is over $20,000. Recently, the general counsel for the Travelers Insurance Company estimated that their defense costs went up 79 percent in the last 5 years.

Yet, it is not the case that goes to trial and results in a multi-million dollar verdict that should overly concern us. It is the thousands of routine cases that are settled because the courts' inconsistencies and their eagerness to find ways to help the claimant hit the jackpot, that have destroyed insurers' faith in the legal process. Who can trust the courts when they change the rules in the middle of the game or rewrite contracts from the bench?

What it all adds up to is not only more and larger claims payments, but higher administrative costs as well. Deplorable conditions like these can be papered over with rate increases and more selective underwriting, but they will not be corrected until the torts system is reformed. We are in the same boat as our insureds. We are all victims of a runaway torts system.

But we in the insurance industry are the first victims in line. It is only a matter of time before the rest of society joins that long list of victims.

At a hearing back in September before the Commerce, Transportation, and Tourism Subcommittee of the House Commerce Committee, NAII vice president and general counsel John Crosby summed up the short-term prospects very well when he said:

"In order to continue to provide the insurance protection necessary for a growing economy, the companies must return to a position of solvency, and this can only be accomplished through price increases. In the short run, this will be traumatic on the budgets of buyers, public and private. To do otherwise raises the prospect of driving a large segment of the industry into insolvency and forcing many buyers of insurance to go bare. As *Forbes* magazine put it not too long ago, 'a world without insurance' would result."

In order to keep prices within some degree of reason, Mr. Crosby suggested the loss side of the equation must be dealt with. And it is here that public pressure for civil justice reform must be brought to bear.

In a number of states, business coalitions have been formed to review the trends which have developed over the past decade and to recommend legislative remedies, such as restrictions on punitive damages, limits on contingency fees, elimination of joint and several liability. In short, they want what we want: the return of reason and common sense in the civil justice system.

The insurance industry is cooperating with State regulators to develop open lines, market assistance plans, joint underwriting associations, and risk pools, to name a few of the voluntary and unilateral actions being taken to address this crisis. The development of the claims made policy will permit more realistic pricing of the commercial liability product.

But these are short-term actions. The real solutions lie with reform in our civil justice system.

Thank you very much for permitting us to appear. We stand ready to answer any questions you may have.

[The statement follows:]

STATEMENT OF CHARLES H. FRITZEL, ASSISTANT VICE PRESIDENT, GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

Ny name is Charles H. Fritzel and I am the Assistant Vice President for government Relations of the National Association of Independent Insurers (NAII).

NAII is a voluntary national trade association of over 500 property and casualty insurers. Our organization provides a truly representative cross section of the property and casualty insurance business in America. Our members range in size from the smallest one-state companies to very large national underwriters, and consist of both stock and non-stock companies. NAII member companies reflect all forms of merchandising—independent agency, exclusive agency, and direct writers; and they include insurers which serve a general consumer market and those which specialize in serving particular consumer groups such as farmers, teachers, government employees, military personnel and truckers.

We very much appreciate this opportunity to testify on what is termed the "insurance availability and affordability crisis."

Just a few weeks ago NAII held its 40th annual meeting. Our outgoing Chairman, Brad Mitchell, who is President of Harleysville Insurance Company in Pennsylvania, in his address to our membership spoke at length about the problems we are facing in the insurance industry. One of his statements stuck in my mind: He said that if a company entered the property-casualty business in 1967, in the 18 years from then until today, it experienced only five years of profitable underwriting. 1984 was the worst year we ever experienced.

In the first six months of this year, the industry's net after-tax income was $1.1 billion, compared to $562 million in the first half of '84, which, at first viewing, looks like an improvement.

But it is not sufficiently understood that the improvement was based on $2.35 billion in realized capital gains and approximately a billion in tax credits resulting from the disastrous loses many companies have incurred in recent years.

The underwriting picture isn't getting any better either. In fact, the industry's underwriting loss rose $1.3 billion over the comparable loss last year. We expect an underwriting loss which will probably exceed $22 billion in 1985.

The bodycount of financially impaired companes hit a record 27 last year. Unlike the previous high of 20 insolvencies in 1975, which lasted only a year, the 1984 level is expected to continue through '85.

For the first time in history, the industry lost $2 billion of its surplus last year solely through poor underwriting experience, at a time when the stock market was relatively stable and investment income was growing.

On top of that, it is estimated that the industry is at least ten per cent underreserved.

In 1984, fifty of the top hundred insurers had returns on net worth that were in the red, a truly shocking performance in view of the fact that only 34 of the Fortune 500 had negative returns.

The usual explanations for the industry's illness include inflation, the recessions of the mid-70s and early 80s, and the bane of cash-flow underwriting.

But none of these is completely convincing. Insurers have weathered inflation and recessions for decades without getting beat up to this extent. And while it is true that some companies, in the commercial lines, nearly perfected Kamikaze pricing cash-flow underwriting has been part of company operations since the 50s, when the shift from property to long-tail liability coverages amassed large amounts of cash in dormant reserves that could be used for investments.

No, something else, is at work and the numbers show it. This year, after six months of rate increases, a stable securities market and substantial investment gains, we still chalked up a disturbing operating loss of $2.25 billion.

The reason is unrelenting, deepening losses. the industry has had five underwriting cycles since the 50s. They have gotten shorter on the upside, longer and deeper on the downside. The first three bottomed out at a combined ratio of 103, the fourth at 108, and the latest one at 118.

Something is pulling insurers deeper under water and holding them there. That something is the civil justice system.

We have all heard about the million dollar judgments and I won't bore you with more horror stories.

For the companies who have to pay outrageous claims, the financial shock can be severe. But they are not really the problem for the industry as a whole. As is usually the way with big things, it is the small, little-noticed changes that, over time, produce the big effect. What's happened to the civil justice system is what workers' comp lawyers call cumulative trauma.

In 1982, over 206,000 civil cases were filed in the federal district courts. No one knows how many were filed in the state courts, but in all likelihood, the number was even larger. In Los Angeles alone, the cost for the average civil case is $20,860. Recently the general counsel of the Travelers estimated that their costs went up 79 percent in five years.

Yet, it's not the case that goes to trial and results in a multi-million dollar verdict that should overly concern us. It's the thousands of routine cases that are settled, because the courts' inconsistences, and their eagerness to find ways to help the claimant hit the jackpot, that have destroyed insurers' faith in the legal process. Who can trust the courts when they change the rules in the middle of the game or rewrite contracts from the bench? What it all adds up to is not only more and larger claims payments, but higher administrative costs as well.

Deplorable conditions like these can be papered over with rate increases and more selective underwriting, but they will not be corrected until the tort system is reformed. We are in the same boat as our insureds—we are all victims of a runaway tort system, but we are the first victims in line. It's ony a matter of time before the rest of society joins the infinite list of victims.

At a hearing back in September before the Commerce, Transportation and Tourism Subcommittee of the House Energy and Commerce Committee,. NAII Vice President and General Counsel John B. Crosby summed up the short term prospects very well when he said, "In order to continue to provide the insurance protection necessary for a growing economy, the companies must return to a position of solvency and this can only be accomplished through price increases. In the short run this will be traumatic on the budgets of buyers, public and private. To do otherwise raises the prospet of driving a large segment of the industry into insolvency and forcing many buyers of insurance to go bare. As Forbes magazine put it not too long ago," a world without insurance' would result."

In order to keep price increases within some degree of reason, Mr. Crosby suggested the loss side of the equation must be dealt with. And it is here that public pressure for civil justice reform must be brought to bear.

In a number of states business coalitions have been formed to review the trends which have developed over the past decade and to recommend legislative remedies such as restrictions on punitive damages, limits on contingency fees, elimination of joint and several liability . . . in short, they want what we want: the return of reason and common sense to the civil justice system.

The insurance industry, along with business and labor, have commissioned a study by the Rand Corporation to analyze the present tort system, and we hope to have those recommendations shortly.

The Insurance Service Office is proposing several changes which could have long-range benefits to the buyer. One is to give insurers (and their buyers) the option of using a "claims made" policy. This option will permit insurers to put a more realistic price on the commercial liability product as it eliminates the uncertainty brought about by claims discovered today that are due to occurrences which happened years ago.

The insurance industry is cooperating with state regulators, not conspiring with them, to develop open lines, market assistance plans, joint underwriting associations, and risk pools to name a few of the voluntary and unilateral actions being taken to address the crisis.

These are some of the actions being taken by the insurance industry. But they are short-term actions. The real solution lies with reform in our civil justice system.

[The following information was subsequently received for the record:]

QUESTIONS OF SENATOR PRESSLER AND THE ANSWERS

Question. In my opening statement you heard me comment on the frustration municipalities in my state have experienced through shyrocketing insurance rates which they tell me have no actuarial basis. How do you set rates in specific states? Is this done state by state, based on claims history or tort laws in any given state or community? Or are rates set on a line-by-line basis without much attention given to specific state or community experiences?

Answer. Essentially, future rates are based on past loss and expense history (not to recoup past losses) to include projections for loss trends in severity and frequency, inflation and the judgment of seasoned actuaries after consideration of many relevent factors, one or several of which in themselves though relevant may not be of primary significance. Rates are not based on the tort laws in a given state but re-

flect the stab of the tort law as manifested in loss payments. Rates are based on state experience as well as territorial experience within that state, and by line where statistics are credible.

Question. As I mentioned in my opening statement, I have been somewhat frustrated by the lack of any hard evidence linking liability insurance rates to the tort laws in particular states. Could the NAII develop information in this area such as:

(a) The relationship between tort laws in a particular state, and the insurance premiums in that state, focusing on the five states the industry feels have the most favorable tort laws, and the five states the industry feels have the worst tort laws;

(b) The percentage of claims paid that were the result of court awards;

(c) The relationship of court awards paid under particular lines of coverage of premiums in those lines.

Answer. As mentioned in the answer to question number 1, loss and loss expense data is the primary focus of future rate making. However, the loss data available does not specifically identify the effects of particular legal doctrines on claim payments. The judgment of professional claims personnel is required to connect the link between general loss data and legal doctrines. However, data from sources outside the insurance industry can often times be found to support this link. The Institute for Civil Justice, has completed studies on punitive damages, collateral sources and non-economic damages which produce some direct data to support the industry's claim that tort and legal doctrines in these areas are responsible for escalating losses. Such direct data is not available to support every proposal for reforming the tort laws in a civil liability area.

Question. Could you please explain what you mean by the insurance industry currently being 10 percent "underreserved?" What is the cause of this reserve shortfall.

Answer. Several factors or a combination of factors cause reserve shortfalls. For example, an initial error in reserving judgment, or inflation, or judicial changes in the tort law, or contract changes by judicial decision after the inception date of the contract itself. Reserving is a method of providing for future payment of losses that have been incurred but not as yet settled. Because the 10% underserving is an industry figure we may assume this is not caused by an individual company's error in judgment. Inflation has been at a minimum of 3.+%, so we must assume that the escalated evolution of tort common law and abolition of policy exclusions, both of which are products of judicial direction, contribute greater to the cause.

Question. What is the focus of the Rand study you have commissioned? Is the study going to specifically document those types of companies or organizations which are sued most frequently?

Answer. We have referred to the focus of some of the Rand studies in answer to question number 2. Under the doctrine of joint liability, the deep pocket theory prevails and you find that municipals and other solvent defendants are more often than not sued, merely to provide payments for losses which were caused by insolvent defendants. For example, under comparative negligence with joint and several liability, an automobile plaintiff may sue the negligent party who is uninsured or underinsured and name the municipality automatically attempting to get the municipality in for at least 1% negligence. Having found the city at least 1% negligent (not a difficult task), the city might well then be called upon to pay the total amount of the plaintiff's damages, barring possibility of recovery from the 99% negligent but insolvent defendant. The age of entitlement had been with us for years but we are now well into the age of enrichment.

Question. Can the NAII provide a breakdown of the percentage of claims paid in 1984 as the result of judicial decisions? What is the relationship between court awards in particular commercial P/C lines and the premiums charged in those lines?

Answer. Basically insurance financial and rating data cannot provide detailed information about legal doctrines or legal areas because the level of detail needed to assess specific legal doctrines cannot be extracted from the source documents that produce financial and rating data. The underlying source documents for categorizing and compiling industry rating and financial data are the policies that set forth the industry's obligations and the claim files containing factual information about loss payments. The components of the industry's financial and rating data—premiums, expenses and losses—are collected, compiled and reported in terms of the type of policy or coverage that is issued. Since all policies and coverage indemnify insureds for a broad range of risks under an infinite number of circumstances, it is virtually impossible to isolate premium, expenses and loss data for a particular risk associated with a particular legal doctrine.

Question. How does the NAII justify premium inceases of 200 to 1000 percent, which are often imposed without regard to a policyholder's past claims record?

Answer. Please refer to answer number 1.

Question. How does the agreement between a primary insurer and a reinsurer affect the coverage and premiums offered by the primary insurer?

Answer. It is necessary for every insurer, large or small, to spread the risks that they insure as a primary insurer. These risks are ceded to reinsurers who further retrocede those premiums and liabilities among other reinsurers, pools, and back to other primary insurers. Assuming reasonable judgments and rates, the reinsurer itself has little affect on coverage and premiums charged by the primary company. We do know that the Lloyds reinsurers will not consider U.S. liability exposure, if the new commercial general liability policy providing for a "claims made" provision is not filed and approved. But that goes to its willingness to reinsure. Once a reinsurer is on the risk, coverage and premiums are usually within the judgment of the primary company. If reinsurers fail to renew certain classes of business due to the escalated evolution of the tort law or improper judicial interpretation of the contracts, the primary company cannot in most cases continue on those classes of coverages. Reinsurance is renewed at various times of the year and its failure of renewal to the primary company would affect all risks with varying expiration dates involved in the company's portfolio. Therefore, when a reinsurer fails to renew or to renegotiate a new contract, those risks within the primary company are total responsibility for the primary company, which threatens its solvency. The primary insurer must do something drastic to reduce its liability or become insolvent.

Question. The current problems in the insurance industry have been attributed to poor underwriting practices, shortcomings of the civil justice system, and the cyclical nature of the industry.

Could you please rate, on a 100 point scale, the relative importance of those three factors, or any additional factors, as causes of the current "crisis?"

Answer. This question cannot be answered with any real credibility.

Question. What specific actions can or should governments take to correct the insurance crisis, and should the action come from the state or federal government? Could you please address your answer to those particular lines of insurance where you feel problems currently exist?

Answer. The civil justice system has grown out of reason. The bounds of manageable and accurate rate settling is illusive and where possible the increases are perceived in some instances as "unaffordable". The strict liability doctrine in products liability, the joint and several liability doctrine in comparative negligence cases, the actions of courts in construing policy exclusions in clear situations to be covered are all problems that must be faced. We would hope that the states would address these problems in an expeditious manner, however, some may feel that the only way true reform is going to become a reality just might be through federal inducements to state reform.

Question. Will the various tort reforms advocated by the insurance industry translate into lower premiums for insurance buyers?

Answer. Absolutely, but not by mandating discounts as these reforms are implemented. As we mentioned in the answer to question number 1, insurance rates are based on loss statistics and as the tort reforms are manifested on losses and the settlement of claims and reduce these losses and settlements, premiums in the future would be stabilized by reflecting these reductions.

Senator PRESSLER [presiding]. Thank you very much.

And thank you, Senator Rockefeller, for chairing the hearing while I was absent. Why do you not begin with your questions, if you would.

I have several questions also which I am going to submit in written form. But let me ask just a couple here.

Particularly, I would like to welcome Norm Sherlock and ask him how many bus operators and other travel-related organizations have gone out of business due to increases in insurance premiums. And if you answered that in your statement, why, you need not repeat it.

Mr. SHERLOCK. Well, I have not answered that in my statement, Mr. Chairman. But we are in the middle of the stream or perhaps the start of the flood. There are a number like the Shubat Bus Company, and as I indicated, they have gone on the public auction block already.

A number of others are at that same point. Many of these enterprises have not yet hit their renewal periods, but I would predict that we are looking at several hundred bus companies, motor coach operators, in the coming year who will be out of business. And if they are not out of business, they are going to be cutting their service back very, very substantially.

It is going to happen also in the restaurant business, the hotel-motel trade as well, and with the snow rental equipment or wherever, as the impact of high liability rates comes down on these people. At least it is going to constrict their profitability. Many will try to hold on for another year or year and a half. Some will not be able to. It will be in the hundreds and perhaps, as we see around the country, maybe in the thousands, particularly in the small business area.

Senator PRESSLER. Yes, I know that the tourism industry is basically made up of small businessmen, and this insurance thing is really becoming a problem. Is that not correct?

Mr. SHERLOCK. Yes, it is. And the thing that disturbs us is it has no correlation in the rates to experience. When you take the example I gave about the motor coach operator, he is paying $120,000 and now has to pay $775,000, he did not have a loss experienced over the last 3 years that would make those rates justifiable, nor do the other examples I have given, where a major theme park has to pay so much as well.

This thing is totally out of hand.

Senator PRESSLER. I also want to compliment Chuck Fritzel, who I have known for many years, originally from my state. I do have some questions.

What percentage of the insurance industry's annual expenses is defense costs?

Mr. FRITZEL. Mr. Chairman, I will have to check on that. I might tell you that the insurance industry, together with some business and labor organizations, have asked the Rand Corporation to do a study on the civil justice system and some of this information is going to come out of that study.

Senator PRESSLER. Thank you.

In view of the time, I will call on Senator Gore.

Senator GORE. Thank you, Mr. Chairman.

I will just ask just a couple here.

I apologize to these witnesses for not being here for the whole hearing, and I want to say that I think this country is underestimating the significance of the problem we are exploring in this hearing today. I feel this inquiry is extremely important and I congratulate you, Mr. Chairman, for initiating it.

My senior colleague from Tennessee, Senator Jim Sasser, had a field hearing of the Small Business Committee in Nashville, TN, at which testimony was presented by many small businessmen from around the

State of Tennessee about the severity of the crisis in insurance coverage. The premiums are going up so rapidly, it is incredible.

At the same time, the amount of coverage purchased by the business person is going down rapidly. I read a number of articles in preparation for this hearing from *Fortune* and *Newsweek* and other publications describing the causes of the problem. I must say the problem is somewhat understandable in light of the chaotic conditions in the economy over the last 10 years.

We must find some solutions for this problem. It is an absolute disaster for so many small businesses and large businesses, too, for that matter, local governments, and professions. The traditional approach of just hands off, let us not worry about it, the market will take care of it, is just not going to be adequate for the situation.

At the same time, the problem is so complex that we do not want to blunder in with some well-meaning proposal that may to create more problems than it solves. So this is a very important inquiry you have started, Mr. Chairman.

One of the solutions that has been advanced, Ms. Canter, is the claims made policy. Yet, I understand from independent insurance agents in Tennessee that the companies have been extremely slow in providing agents the information they need to fairly provide this coverage to their customers.

Have you heard similar complaints from agents in other states?

Ms. CANTER. Senator, that is a subject that has been a subject of a tremendous amount of conversation within my Independent Insurance Agents Association here locally. In fact, there was a luncheon about two weeks ago with 20 local branch managers of insurance companies within the area, and the topic of discussion was when they were going to be ready to implement the claims made forms.

January 1 was the target date that the switchover would take place. There was not one company represented there who said that they would be in full gear by January 1st to go with the claims made form. Most of them said that hopefully by February 1, March 1. Some were using the date of June to July 1 before they would be full steam ahead to go ahead with that.

Senator GORE. Does anybody else want to comment on that briefly?

Mr. HEYDINGER. As I mentioned, RIMS is suggesting disapproval of the ISO CGL approach, the claims made approach. I think a couple of points I would make.

Senator GORE. "CGL" meaning commercial general liability?

Mr. HEYDINGER. Correct, Senator.

The point I want to make is that I think by ISO's own admission, they claim that it is necessary to deal with those long latency problems and produce the predictibility we have heard so much about. But they also say that is only five percent of the risk that is out there, and we ask why do we need such a broad, sweeping change across the other 95 percent of policyholders?

And also what concerns us is claims made is nothing new. It has been around for a number of years. It has been the only product available for products like directors and officers liability and some of the professional liabilities. Yet those are the very same lines of insurance that have real shortages and availability problems today. And if it did not work for them, why will it work across the board?

Those are a couple of things to think about.

Senator GORE. Now, a couple of other things, briefly. There have been proposals on dealing with the tort aspect of the problem, but I have been frustrated by the lack of any good statistics on a State by State basis that outline the tort problem.

Mr. Fritzel, do you have any such statistics that you could provide the committee?

Mr. FRITZEL. I do not have them with me.

Senator GORE. I mean, we always hear references to some of the high claim states.

Mr. FRITZEL. It is obvious that there is a problem because of the coalitions that are springing up in various States to address this problem. I have a list here somewhere of some of those.

Senator GORE. I am aware of the coalitions, but the statistics are what I would like to get.

Mr. FRITZEL. I think that Rand study that I mentioned will produce some of that. I also have here a 1985 tort law enactments by the states. These are laws that were enacted this year in the various States to address the various aspects of tort reform and problems. So I think that the evidence by this indicates that the State legislatures are aware that there is something going on. The people are concerned about what is happening with their judicial system.

Senator GORE. Well, there is no question about that. But if you could provide to me, to the committee, any State by State statistics, that would be helpful.

One final question to anybody on this panel who wishes to respond. What would you think of a proposal to modify the Risk Retention Act of 1981 to allow small businesses to form risk retention groups, as product manufacturers may now do?

Mr. HEYDINGER. Well, RIMS obviously would be very supportive, and it is a vehicle that is available to products liability manufacturers. I guess it has recently been included in the reauthorization of Superfund for pollution liability. I think it definitely should be considered on a broader usage basis.

Senator GORE. Does anybody disagree with that?

Mr. SHERLOCK. We would concur.

Senator GORE. Thank you, Mr. Chairman.

Senator PRESSLER. Thank you very much.

I want to say to this panel, we could spend several hours questioning you. I have close to 20 questions for each of you that my staff has prepared, and I want to thank them for their hard work. But in the interest of time, we shall be moving forward to our last panel, and I will submit those questions for the record.

I would call forward: Mr. Mark Ferraro, risk manager, City of Dallas; Mr. David M. Farmer, vice president, Federal affairs, Alliance of American Insurers; Honorable Francis H. George, mayor of Cheverly, MD; and Honorable Arden D. Ashley, mayor of Nitro, WV.

I am sorry, it is Mayor Gerard Quinn, Gerard Quinn, mayor of Sharpsburg, MD, rather than Mayor George.

Who wishes to proceed first? A volunteer? Mr. Ashley.

STATEMENTS OF ARDEN D. ASHLEY, MAYOR, NITRO, WV; DAVID M. FARMER, VICE PRESIDENT, FEDERAL AFFAIRS, ALLIANCE OF AMERICAN INSURERS; GERARD QUINN, MAYOR, SHARPSBURG, MD; AND MARK FERRARO, RISK MANAGER, CITY OF DALLAS

Mr. ASHLEY. Thank you, Mr. Chairman, and greetings to the members of the subcommittee from the beautiful State of West Virginia and its hopeful people. I commend you for conducting these hearings and I applaud you for including our insurance crisis on the agenda.

I am Mayor Arden Ashley from the City of Nitro, WV, President of the West Virginia Municipal League and member of the board of directors of the National League of Cities.

After hearing the earlier testimony, I am sure you have a full understanding about the depth of the problem that everyone faces with the costs and availability of liability insurance. We are in the midst of a national crisis, but even worse, this crisis is insidious in that it does not have the visibility of the recent floods that have ravaged our region of the country, for example. It is more like a cancer, and I would submit to you that the ultimate result can be just as bad.

If indeed I can get you to accept the hypothesis that local government is the foundation of our nation's governmental structure, closest to the people, then I can tell you that our society is in great jeopardy. I would like for you to think on that point and come back to it later.

But first, let me identify some of the real problems being faced back home. Back home to me, as I said, is in West Virginia. West Virginia is a State of some 2 million people, smaller in population, in fact, than many of our nation's major cities. We have 230 cities, with well over half of them enjoying a population of less than 5,000 people.

We have no city of 100,000, but I can tell you, and perhaps would get some support from at least one member of the committee, that we could probably put 100,000 people in Mountaineer Field on a fall weekend if the stadium would just hold them.

We are a small State and we are a State with a big heart and some of the greatest little towns you could ever imagine. They are the kind that you would be reminded of by Norman Rockwell. And I would like to tell you about some of them and their problems.

There is Williamson, WV, on our southern border next to Kentucky. They have no liability insurance, and in a regional council chaired by its mayor he advises us that 9 of the 25 cities in the 6-county region have no liability insurance.

Belle, WV, a small city in my county, has no liability insurance, and its mayor says that the problem "endangers the very existence of small towns."

Wheeling, WV, they have insurance. Their premiums went up in the past year from $113,000 to $240,000. Chapmanville, their premiums went from $14,900 to $25,000, while the deductibility was increased from $500 to $1,000. In Putnam County, the premiums went from $27,000 to $107,000.

The little town of Addison, the premium went from $1500 to $3485 per year, and the mayor advises that she doubts that she can find the means to purchase the vicarious liability coverage.

Rainelle, WV, no liability insurance. Northfork has quadrupled in premium cost over the past year, and they feel fortunate to get it at that price. South Charleston, their mayor reports that their premiums have increased fourfold during the past year. And the little town of Ranson, not too far from Washington, DC, Mayor Lance reports that they have never had an insurance claim; yet their policies are being dropped.

From Fairview, WV, their mayor reports that in just a matter of months their premiums for coverage have risen 350 percent. Ansted, WV, no insurance. Lewisburg, WV, no insurance, and my friend Mayor Phil Gainer says: I am desperately seeking another insurer prior to the December 16 expiration date.

So there you have some of the specific problems being faced by mayors and commissioners from across West Virginia. Now, many of these people are personal friends of mine and I feel a sense of their despair, and I hope that perhaps you will as well.

And by the way, it occurred to me that you might want to know what one of the forms looks like when they advise you of cancellation or non-renewal. So I brought the one from the city of Nitro. I received mine last Wednesday. I had earlier mentioned—

Senator PRESSLER. We will make that a part of the record. Thank you.

[The material referred to follows:]

NOTICE OF CANCELLATION OR NONRENEWAL

TYPE OF POLICY: LAW ENFORCEMENT PROFESSIONAL LIABILITY INSURANCE POLICY

POLICY NO	ISSUED THROUGH AGENCY OR OFFICE AT	CANCELLATION OR TERMINATION WILL TAKE EFFECT AT (DATE) (HOUR STANDARD TIME)	DATE OF NOTICE
PLE84 004322	SPECIAL RISKS, INC. SUITE 201 4663 HAYGOOD ROAD VIRGINIA BEACH, VIRGINIA 23455	02/20/86 12:01 A.M.	11/22/85

UNITED STATES POSTAL SERVICE

AFFIX POSTAGE AND POSTMARK

(ONE PIECE OF ORDINARY MAIL ADDRESSED TO)

NAME AND ADDRESS OF INSURED: NITRO POLICE DEPARTMENT
& CITY OF NITRO
20TH STREET & 2ND AVENUE
NITRO, WVA. 25143

RECEIVED FROM

INSURANCE COMPANY: IMPERIAL CASUALTY & INDEMNITY COMPANY

FOR USE AS A "CERTIFICATE OF MAILING" AS PROVIDED IN PART 165 OF THE POSTAL SERVICE MANUAL.
MAY BE USED FOR DOMESTIC AND INTERNATIONAL MAIL. DOES NOT PROVIDE FOR INSURANCE.

CERTIFICATION

I HEREBY CERTIFY THAT I PERSONALLY MAILED IN THE U.S. POST OFFICE AT THE PLACE AND TIME STAMPED HEREON, A NOTICE OF CANCELLATION OR NONRENEWAL TO THE INSURED AND, IF REQUIRED, TO THE LIENHOLDER, AN EXACT CARBON COPY OF WHICH APPEARS ABOVE, AND AT SAID TIME RECEIVED FROM THE U.S. POSTAL SERVICE THE RECEIPT MADE A PART HEREOF OR ATTACHED HERETO.

SIGNED THIS 22nd DAY OF NOVEMBER 19 85

SIGNATURE Rebecca A Wright

APPLICABLE ITEM MARKED "X"

CANCELLATION

☐ YOU ARE HEREBY NOTIFIED IN ACCORDANCE WITH THE TERMS AND CONDITIONS OF THE ABOVE MENTIONED POLICY THAT YOUR INSURANCE WILL CEASE AT AND FROM THE HOUR AND DATE MENTIONED ABOVE
IF THE PREMIUM HAS BEEN PAID, PREMIUM ADJUSTMENT WILL BE MADE AS SOON AS PRACTICABLE AFTER CANCELLATION BECOMES EFFECTIVE.
IF THE PREMIUM HAS NOT BEEN PAID, A BILL FOR THE PREMIUM EARNED TO THE TIME OF CANCELLATION WILL BE FORWARDED IN DUE COURSE.

☐ YOU ARE HEREBY NOTIFIED IN ACCORDANCE WITH THE TERMS AND CONDITIONS OF THE ABOVE MENTIONED POLICY THAT YOUR INSURANCE WILL CEASE AT AND FROM THE HOUR AND DATE MENTIONED ABOVE DUE TO NONPAYMENT OF PREMIUM.
A BILL FOR THE PREMIUM EARNED TO THE TIME OF CANCELLATION WILL BE FORWARDED IN DUE COURSE.

☐ YOU ARE HEREBY NOTIFIED IN ACCORDANCE WITH THE TERMS AND CONDITIONS OF THE ABOVE MENTIONED POLICY THAT YOUR INSURANCE WILL CEASE AT AND FROM THE HOUR AND DATE MENTIONED ABOVE.
YOU ARE HEREBY ADVISED THAT THE LAW PROVIDES THAT UPON REQUEST IN WRITING MADE BY YOU TO THIS COMPANY, SUCH REQUEST TO BE MAILED OR DELIVERED NOT LESS THAN 15 DAYS PRIOR TO THE EFFECTIVE DATE OF CANCELLATION, YOU ARE ENTITLED TO BE INFORMED BY THIS COMPANY IN WRITING OF THE REASON(S) FOR THE CANCELLATION.
IF THE PREMIUM HAS BEEN PAID, PREMIUM ADJUSTMENT WILL BE MADE AS SOON AS PRACTICABLE AFTER CANCELLATION BECOMES EFFECTIVE.
IF THE PREMIUM HAS NOT BEEN PAID, A BILL FOR THE PREMIUM EARNED TO THE TIME OF CANCELLATION WILL BE FORWARDED IN DUE COURSE.

NON-RENEWAL

☒ YOU ARE HEREBY NOTIFIED IN ACCORDANCE WITH THE TERMS AND CONDITIONS OF THE ABOVE MENTIONED POLICY THAT THE ABOVE MENTIONED POLICY WILL EXPIRE EFFECTIVE AT AND FROM THE HOUR AND DATE MENTIONED ABOVE AND THE POLICY WILL NOT BE RENEWED. 1-1-86 NON-RENEWAL, THUSFAR, OF RE-INSURANCE AND NEW WORDING OF POLICY.

TO: ADDITIONAL INSURED (NAME AND ADDRESS)

AGENT

DVUA OF WEST VIRGINIA, INC.
1120 KANAWHA BLVD., EAST, SUITE G-6
CHARLESTON, WVA. 25301

Mr. ASHLEY. I mentioned we had a problem of such a magnitude that our society is in fact in jeopardy. I am now prepared to elaborate on the point in an attempt to persuade you that that is not an exaggerated statement, because behind many of the comments that I have referred to from the mayors across the State there is an underlying fear. Here are a few of the examples.

Mayor Benny Capparelli, is from Northfork and he says: "Unless something is done, there is not going to be any small or large municipalities due to the fact that they cannot afford the high premiums, even if they are fortunate enough to secure liability insurance."

From the Boone County Commission, again I quote: "The absence of these coverages could seriously affect the willingness of responsible persons to serve in the capacities of law enforcement or public office."

And from Cabell County, they say: "The quickest way to drive a responsible citizen from local government service is to end liability insurance coverage. This situation is most critical and needs immediate attention.'

From the Raleigh County Commission, they say: "It should be obvious that, given the litigious environment local government officials have been thrust into during the past decade, without proper insurance coverage few local government officials can afford to continue to serve."

Perhaps the most graphic example of all, though, comes from the little town of Grafton. They attempted a wholesale resignation of the council and they were informed by the Secretary of State that this represented a violation of their oath of office and they were required to continue to serve until such time as they found replacements.

And I guess the final example should be one from my city. We have had a professor from a nearby college refuse to serve and resign from the planning commission. Recently an insurance executive submitted his resignation and said he just did not like being sued any more. And as for me, I have made it clear that I am stepping down at the end of this term. And I might further add that if we run out of liability insurance before the end of the term, I will resign.

So we have discussed cities that are paying increased premiums at unbelievable rates, others who cannot obtain insurance at any rate, and officials who are giving up or trying to. So the question that obviously follows is, what if these cities do collapse?

And that takes us back to the role of local government in our society. I would submit that democratic self-government at the local level is the very keystone of our free society. It is at this level that our citizens learn how to govern themselves.

And as you assess where we are, I would also remind you that the problem is not on its way. It is here right now. If these cities that are on the edge are to survive, it will only be because you have saved them through positive action. In 1945, the McCarran-Ferguson Act gave the authority to regulate insurance to the States without standards for regulations. At that time in history, the insurance industry was much more local in nature.

Now we find this cyclical international industry that has run amok. Much of our liability insurance in West Virginia comes from foreign companies, and no State is in a position to control the insurance companies doing business within their boundaries today.

The reinsurance business comes from corporate giants making national policy decisions. And the fact that Logan, WV, has had no claims makes no difference to the reinsurance carrier. Logan's insurance was not renewed.

One answer for you then is to consider a move to rescind or modify the McCarran-Ferguson Act, thus enabling the States to address the problems through the help of Federal regulations. While my role in testifying today is on behalf of local governments, we recognize that the problem is much broader than that and so much out of hand that it is only through Federal intervention that the highs and lows of the cycles that the industry has experienced can be smoothed out.

While we are struggling with our respective State legislatures back home, we can only come up with short-term relief that offers us an opportunity to circle the wagons and try to survive until the cavalry comes. For example, if we are successful in obtaining a liability cap and/or some degree of immunity for public officials, it would still be meaningless if our reinsurance companies are not offering to provide us with coverage.

Of course, in dealing as we have with the problems that I have presented today, we are really begging the question. The problem in this litigious society is that the greed of some has found a softness and they are capitalizing on it. You have heard from various sources about the growing statistical probability of suits and the astronomical rewards for such action.

With suits against public officials increasing 50 percent in the past three years, it simply becomes a matter of time until you become one of the victims. It is significant that in 1962 there was one municipal liability case with a jury award of a million dollars and in 1982 there were 251. Unfortunately, judgment on the cases being heard and the awards being given is apparently not part of your task. Therefore, my appeal to you, the members of the subcommittee, would be that you join us in working within the system until such time as greater changes can and will be made.

I commend you for your efforts. I wish you godspeed in your deliberations and pray that the effort that you put into the problems we face will result in solutions that will be of service to all the people of the nation.

Thank you very much for your kind attention.

Senator PRESSLER. Thank you very much.

Mr. Farmer.

Mr. FARMER. Thank you, Mr. Chairman. I think it is particularly appropriate that I will be the final witness for the insurance industry, and will follow the gentleman from West Virginia with insurance problems.

There is a crisis in liability insurance, but the crisis is not in insurance. The crisis is in the civil justice system of the United states. The insurance industry is before you this morning and individuals and municipalities are questioning how much—how many dollars did we take in and how many dollars did we take out. I think to really get good understanding of the civil justice system, one needs only to ask the Department of Justice how many civil cases are being brought against the U.S. Government.

One needs to ask the Union Carbide Company about the civil justice system. One needs to ask the president of Texaco what about the civil justice system in the United states. One needs to ask the president and board of directors of the Dow Chemical Company what about the civil justice system of the United states.

Many of these entities and the U.S. Government are self-insured. There is no liability insurance involved with the U.S. Government, but I would venture to say that the number of suits, the amount of the awards is significant and growing, and so I think that in order to focus on the problem of liability insurance we need to focus on the civil justice system.

In terms of our policyholders, whether they be day care centers or whether they be municipalities, whether they be doctors, whether they be lawyers, we are concerned in terms of the actions that have been taken that have been harmful to their individual communities and individual lives. These are actions that were not taken lightly without disregard to the consequences.

We are here today because of business judgments taken by individual insurers. All of us aren't here though. I can name you insurance companies that would like to comment on the State of the civil justice system, and they are not here. Two of those were members of our association. They are gone. They have been declared insolvent.

So we do have a crisis in America in liability insurance. That crisis is in the civil justice system. Left unchecked, this system will destroy the ability for victims of accidents to be compensated. The tort system is in danger of dying. I am a member of the DC Bar Association and received just the other day a brochure on Liquor Liability Symposium.

The first paragraph says "Victims and their families are eyeing the deep pockets of alcohol service and insurance industries as the value of the average liquor case increases dramatically," and described a video as to how to go ahead and to pursue a liquor liability case. In terms of the reforms that need to take place, this body and the House have the opportunity.

Superfund is up for renewal. The Senate has acted in terms of joint and several liability, and by their action indicated that a de minimis defendant is liable for the whole amount. The Senate did not act in terms of motor carriers. The U.S. Congress decided that the limits of liability needed to be increased in order to protect the public, so we moved the limits up to $5 million.

Companies are having difficulty in obtaining those large limits. The insurance industry in response to Senator Rockefeller's earlier claim is not without total guilt. We did not price the product adequately at the time that we were charging less than it cost to produce that product.

And the civil justice system was going in the opposite direction. We were charging less with the expectation that investment return would overcome that. It turns out that it has not. We have serious financial difficulties. No one—the buyers, no one questioned on the down side when we were charging 10 percent of what we should have charged, no one questioned those prices.

At the present time almost every insurance commissioner is concerned and is having hearings. Twenty-six States have packages of legislation that are going be considered in 1986 in order to address this problem, limiting our ability to cancel policies, changing the rate regulatory system in response to what would happen if you repealed McCarren. McCarren provides the system whereby the States determine the type of rate regulation you have. If you were to totally repeal McCarren, put the industry under antitrust, insurers could charge anything that they wanted, and there would be no regulation.

In summary, we want to cooperate with this Committee. We want to cooperate with the Congress. We want to cooperate with State government. We believe that tort reform is necessary today and not tomorrow.

Thank you, Mr. Chairman.

[The statement follows:]

STATEMENT OF THE ALLIANCE OF AMERICAN INSURERS

Mr. Chairman, my name is David M. Farmer and I am Vice President, Federal Affairs, for the Alliance of American Insurers. The Alliance is a voluntary membership organization composed of over 179 property and casualty insurers. Our members provide property and casualty insurance to millions of homes and businesses throughout the United States. We are pleased to have this opportunity to address the issue of liability insurance.

During recent months, there has been expressed an increasing concern from some quarters about the problems of securing liability insurance for some businesses and professions; for others, concerns about cost have been expressed. From the outset, let me say that we share the concerns of affected industries. Actions taken by individual insurers that have an adverse impact on our customers are not ones that are taken lightly or without an awareness of the consequences. We believe, however, that business judgment necessitated the actions that have occurred.

We appreciate the opportunity to describe for this subcommittee what is occurring in the liability insurance marketplace.

You need to examine several areas—legal, financial and regulatory to adequately understand what is happening to property and casualty insurers.

The legal climate is not a static environment, it is a changing one. One which society, through legislative and judicial bodies, determines the rights and remedies of parties to a dispute. Over the past ten years, some significant changes have occurred. In state courts, the latest studies show an increase in litigated cases of 22 percent from 19744–1981. In 1962, only one civil award amounted to $1 million. In 1982, there were 251 awards.

The cost of the system is enormous. The Institute for Civil Justice found that in asbestos cases injured plaintiffs received ony 37 percent of the available dollars. Litigation costs consumed 63 percent of those dollars paid. Of that amount, 37 percent was the average defense expense and 26 percent being average plaintiff expense.

In an editorial "Why It Got Paid", the New York Times on March 8, 1985, cited the abuses in the agent orange litigation. Explaining how "orangemail" works, the editorial said, "Hordes of personal injury lawyers sign up the alleged victims of a toxic chemical, creating the prospect of such costly litigation that the manufacturers are driven to settle even if no connection between injury and chemical can be proved. Having shaken down the companies, the lawyers claim so much for themselves that victims are left with trivial payments."

Complimenting the court in the manner in which the disputes are being resolved, the editorial concluded.

"Best of all, Judge Weinstein may also have fashioned a partial remedy against orangemail in other cases, by slashing the orangemailers take. He set lawyers fees on the basis of how much each lawyer contributed to the case."

The problems of a runaway civil justice system are by no means confined to private defendants "for the twelve month period ending March 1984."

U.S. Deputy Attorney General Carole Dinkins reported that nearly 111,100 cases involving the U.S. Government were filed in the Federal District Court.

The civil justice system in this country needs change—not tomorrow, but today. Left unchecked, this system will engulf our ability to compensate victims of injuries. Already, the insurance industry has lost the ability in certain lines to adequately price the cost of coverage.

Liability insurance is a vital part of our modern economy and because of governmental mandate, a necessity for some businesses.

One example illustrates this situation. Recently, the EPA had to decide whether or not to suspend the requirement for mandatory liability, for the operators of hazardous waste sites. In a recent hearing before the House Energy Subcommittee, an EPA official stated the reasons the coverage requirement was not suspended, was that without insurance "adequate protection may not be provided to human health and the environment."

While we certainly understand the reasons for that position, it is stated by state and federal regulators for a variety of coverages. I would like to remind the Subcommittee that the casualty insurance industry despite significant resources has a finite supply of capital, as of this moment, probably around $57 billion. The Office of Technology Assessment recently estimated that the cleanup of hazardous waste sites would cost $100 billion.

Even if that figure is high and if casualty insurers are expected to pay, there aren't enough dollars.

An industry observer at a symposium on hazardous waste held on November 18, stated the problem rather succinctly, "environment impairment liability insurance created in 1982, by 1984 has one or two markets. The finer of blame must be pointed not at the judiciary but at legislative and regulatory arms of government on the other hand, responsibility for the effects of overreaching construction of the pollution exclusion must be placed entirely on the shoulders of the judiciary" (William Mahoney, Marsh and McClennan—2nd Annual Hazardous Waste Symposium November 18, 1985). We agree with that assessment.

On the financial side, the industry is expected to complete 1985 as another record year for losses. This follows 1984 where income from all sources was not sufficient and the industry suffered a reduction in capital of some $3 billion. Those are losses over and above premium and investment income.

In this difficult environment, insurers face problems where they must allocate available capital. In lines of business where there is uncertainty about the present and future, companies are no longer providing coverage. A number of casualty insurers are in a difficult financial position and some carriers have gone out of business.

We have seen problems in a variety of liability coverages, although I would add that the problems are not occurring in every state or jurisdiction. They vary by state and by line of coverage. In many cases, there are direct correlations between the underlying state statute the type of rating law and the approach taken by state government.

In the following pages of my testimony, I will attempt to describe some of the problem areas of liability coverage and some possible solutions.

MUNICIPAL LIABILITY

The municipal liability problem can be traced to the erosion of a well-settled principle of law that governmental entities could not be sued without their consent. That is, the federal and state governments and municipal corporations which have power to legislate, as well as counties, townships, and unincorporated divisions of a state, traditionally were not liable for damages for their neglect of public duty.

Since the mid-1970s, state legislatures and the judiciary have significantly eroded the doctrine of sovereign immunity, particularly in regard to municipalities. In some cases, amendments to state constitutions or changes in state laws, totally or partially abolished sovereign immunity as applied to local units of government, particularly as to municipalities. In addition, the courts generally hold that where the legislature by statute abrogates the immunity of the state from liability, such laws also repeal the immunity of municipal corporations, counties, towns and all other political subdivisions of the state.

Not only have the courts eroded the doctrine of sovereign immunity, they also found other avenues to create liability where none previously existed. The courts have held municipalities liable for violation of the constitutional rights of citizens and have also required municipalities and other local government entities to indemnify claims against municipal employees.

Recent surveys indicate the dramatic growth in the size of judgments and awards against cities. Based on a 1982 survey of 937 cities, the largest amount sought was $40 million. In 1985, the 1,244 cities surveyed responded that the average claim was in the $100–$200 million range. The average award jumped from $230,000 in 1982 to $2 million in 1985. Additionally, the number of lawsuits filed against public officials doubled since 1982.

Solutions to these problems are being actively considered by states, including the reestablishment of sovereign immunity, at least on a basis limited to certain defined activities; the adoption of better risk management activities (e.g., equipment maintenance, loss control plans); improved safety plans; the elimination of some hazardous municipal series (e.g., hazardous substance treatment or disposal); and limitations on recovery of damages sought in citizen suits.

DAY CARE

Insurance availability problems associated with professional and family day care providers are of recent origin. Publicity associated with sexual and physical abuse in day care facilities is expected to increase both the frequency and severity of insurance claims. The potential of judicial application of absolute liability and the probable delayed development of claims resulting from long term evaluation of the day care providers have made underwriters cautious. Attorneys are now seeking to circumvent policy exclusions for sexual, physical, and criminal abuse by alleging negligent hiring in day care centers.

A major problem in this field is the lack of licensing, background checks, regulations, inspection and standards for the family or home-based day care provider. While these day care services may appear on the surface as casual day care accommodations, many are indeed businesses and should be treated as such.

Insurers are working with insurance commissioners and legislators in several states to assure a viable insurance market for the professional and family day care providers. This includes evaluation of homeowners insurance coverages to identify and define and distinguish the family day care provider as a business enterprise and as child care accommodation.

LIQUOR LIABILITY (DRAM SHOP)

A recent National Commission Against Drunk Driving study estimates that half of the 43,918 U.S. motor vehicle fatalities in 1984 were alcohol-related, based on data from 16 states that test the blood alcohol levels of all drivers involved in serious accidents. The frequency of alcohol-related traffic accidents and fatalities is currently receiving widespread public attention.

There has been strong public clamor over the past decade for enactment of stricter laws aimed at reducing the number of intoxicated drivers on the road and for enforcement of those laws once they are enacted. Another perceived means of deterring drunk driving is the enactment of "dram shop" laws which specifically establish the civil liability of a liquor licensee who sells or provides alcohol to a minor or other intoxicated person who later causes a motor vehicle accident.

In most states, the current availability problem in liquor liability insurance is primarily for those liquor licensees who try to secure only dram shop insurance (monoline coverage) rather than for licensees who secure insurance as one part of a commercial lines insurance package.

Even when dram shop coverage is written as part of the commercial insurance package, commercial lines underwriters on both new and renewal business are looking at the individual insured more selectively in terms of risk characteristics and claims experience.

The reason is primarily the inceased public awareness of the dangers of drunk driving, which in turn has led to the recent large court verdicts and settlements in dram shop cases. In the changing climate surrounding liquor laws, insurers believe that they can no longer adequately assess their exposure under dram shop policies.

In addition, insurance coverages can be more predictable if a reasonable limit or cap on damages which may be awarded under a dram shop statute, both per person and per incident or occurrence is instituted.

MEDICAL MALPRACTICE AND NURSE-MIDWIFE

Until recently, medical malpractice insurance suffered less from availability problems than affordability problems. Recently, however, the availability of coverage for certain specialties have emerged. These include nurse-midwives, obstetricians, gynecologists, and family practitioners doing some obstetrics and pediatrics. In addition, insurers, including non-traditional insurers such as those owned by the medical profession, have reduced contract limits and coverages.

Insurance coverage for nurse-midwives that is not integrated into a complete insurance package for physicians and related professions has been difficult to place. Insurers are concerned about the training and experience of those in this profession in light of the degree of risk and potentially high liability exposure associated with their medical practice.

Medical malpractice insurance is written both by specialty writers, usually physician sponsored, and insurance companies. In addition, ten states have active joint underwriting associations comprised by law of licensed insurers in the state. In 1984, more than half of all medical malpractice premiums were written by specialty writers. Of the top 20 companies, 12 are specialty writers and, with the exception of two or three, all were formed after 1975. Over the period 1980–1984, nationwide, the combined medical malpractice carriers reserved $1.61 in claims and administrative expenses for each premium dollar earned. The obvious financial problems associated with this financial picture, however, are limited to a few states where rate increases have been inadequate. Thus, a core problem associated with inadequate medial malpractice coverage is the lack of adequate rates approved by insurance departments to support growth in capital and surplus. Inadequate rates give rise directly to solvency and financial concerns and limitations on coverage availability.

The reforms suggested for medical malpractice proceed from the basic notion that the availability problem can be managed if the rise in claims frequency and severity can be controlled, if incidents of actual malpractice can be reduced in number, and

if the predictability of long-term risks can be increased for companies writing coverage.

Peer review in the medical profession is vital and must be made more effective in reducing the incidence of malpractice. Mandatory sanctions should be provided by statutory enactment so that not all decision-making in peer review will remain discretionary. Doctors and other health care providers should be required to report their open and closed claims record prior to licensing, and a claims record including a specified number of awards over a certain amount during a specific time period should be established as grounds for mandatory non-licensing or suspension of a license.

Hospitals should institute risk management programs which will monitor the competence and claims records of practitioners and which will impose sanctions if standards are not met. Hospitals should require disclosure of claims records including all judgments, settlements, and pending claims before granting privileges.

Immunity should be provided by statute for all persons engaging in good faith in peer review or reporting.

The most effective option addressing the medical malpractice availability problem is tort reform. One of the most significant of these tort reforms is the enactment of caps or limitations on the total amount of damages which may be awarded in a malpractice action. Where the enactment of a comprehensive cap covering all damages is not feasible, a cap covering the damages most suspectible to jury inflation, non-economic damages, should be enacted. Non-economic damages include pain and suffering, loss of consortium, loss of society and emotional distress. An absolute bar to the award of punitive damages should be enacted; where this is not possible, caps should be imposed and a higher standard of proof should be required which would ideally limit awards to only those cases where willful and wanton action, fraud or malice can be shown beyond a reasonable doubt.

A group of reforms which deals chiefly with procedures for bringing and conducting malpractice suits have been suggested. A plaintiff should be required to file a notice of intent to sue prior to filing a complaint, and should be required to accompany his complaint with a certificate of merit from a health care provider of the same specialty as the practitioner being sued. Mandatory alternate dispute resolution mechanisms should be enacted. All claims should be required to go through a screening panel to determine if there is a reasonable likelihood that the plaintiff is injured as claimed.

Sanctions, including award of attorneys' fees and costs, should be taxed against plaintiffs bringing frivolous claims. Provisions making inadmissible evidence of a plaintiff's compensation from other sources should be abolished, and a provision for the offset of collateral sources should be put in place. Provisions stipulating that the partial payment of a claim shall not be construed as an admission of liability, and that evidence of such partial payment is inadmissible should be enacted. New standards for expert witness should be enacted requiring that they be licensed practitioners of the same specialty and from the same locality as the defendant practitioner.

Courts should require medical malpractice juries to bring back itemized verdicts, separating awards into amounts for economic and non-economic damage and into amounts for present and future damages. Courts should allow the payment of awards by means of structured settlements; periodic payment of awards should be allowed where the parties agree to such payment.

MOTOR CARRIER LIABILITY

Against the background of generalized property/casua.ty insurer problems, the requirements for high limits of liability as mandated by the Motor Carrier Act of 1980 and the Bus Regulatory Reform Act of 1982 have placed a severe strain on the capacity of insurers and on their ability8 to accurately ascertain a financially sound course of action.

In addition to excessive financial responsibility limits of these statutes, other reasons for the current problems include:

"Deterioration in the quality of risks, particularly with regard to marginal operators and new operators who are less financially stable and have no safety record in their operations.

"Further, a number of states including Colorado, Connecticut, Indiana, and Pennsylvania have enacted or introduced within the last year, legislation which extends the federal financial responsibility requirements to risks operating intrastate."

Solutions to availability problems include the redefinition of the types and sizes of motor carriers and passenger carriers required to carry the higher limits. In this context, an attempt should be made to exempt local carriers operating only intra-

state from the federal requirements, leaving them to be separately regulated by the states. Other exemptions might be considered for carriers having only slight exposure to loss, based on maximum quantity and/or frequency or hazardous materials carried.

POLLUTION LIABILITY

At the center of problems associated with the availability of pollution liability insurance is the fact that liabilities against policyholders for cleanup, personal injury, and property damage are created by multiple federal and state statutes as well as by common law. Interacting with this are court interpretations of prior insurance contracts expanding coverage beyond that which insurers intended. As a result, availability of insurance for current pollution liability is significantly influenced by insurer's concern about potential unanticipated past liability; the magnitude of potential pollution liability, both past and future; the seeming inability to use contract language to prudently limit insurers' exposure; the complexity and expense of underwriting the coverage; the unsettled state of the technology used to dispose and clean up toxic and hazardous substances; the fact that demand for coverage has been confined mostly to entities with a high probability of sustaining large losses, causing problems in risk spreading; and a civil justice system that continues to create new theories of liability and to expand older theories.

Further adding to insurer's uncertainty, is that these other events occurred at a point in time when environmental impairment liability insurance was just beginning to be offered by relatively few writers and little claims data was available.

In discussing solutions, it is necessary to separate fundamental solutions from short-term transitory ones. Furthermore, solutions for one statutory problem may have relevance in other settings but require separate action. Amendments to the Federal Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) the Superfund law, also would be applicable to the state copies of Superfund (about 40 states). Moreover, amendments may be necessary to one law only to increase the likelihood of coverage under another. For example, one factor in the lack of available insurance to meet the financial responsibility requirements of the Resource Conservation and Recovery Act (RCRA) is the fear that today's RCRA sites will become tomorrow's Superfund cleanup target. It also must be recognized that sometimes two events converge to produce a problem. For example, the insurer problems with Superfund are the result of the provisions of the Superfund law, as administered by the EPA, interacting with state court decisions reading out coverage limitations or exclusions in insurance policies regarding pollution liability.

Problems under the federal Superfund law include:

"*Retroactive Liability*—The provisions of the Superfund law apply retroactively to owners and operators of waste sites, transporters, and those who generated waste disposal at the site.

"*Strict Liability*—Liability exists even though the responsible party's acts or omissions were not the proximate cause of the leak and even though the substance leaking is not that deposited.

"*Joint and Several Liability*—The majority of courts ruling have held responsible parties jointly and severally liable and ignored degree of contribution to the toxic site.

"*Excessive Transaction Costs*—The present responsible party approach to Superfund combined with joint and several liability has resulted in high transactions costs. The moneys spent by EPA could better be used to clean up sites while insurers have faced investigation and legal costs that frequently are far in excess of any potential Superfund cleanup share."

CONCLUSION

Insurers recognize the social and commercial necessity of their product as well as the integration of insurance with sound public policy. The underlying problems in the environment of certain businesses as reflected in availability and affordability problems for certain coverages, deserve thoughtful solutions by insurers, their policyholders and public policymakers. These problems do not exist in all lines of commercial insurance, nor in all states nor to the same degree in each affected commercial activity. The prospective solutions vary in their applicability to each such problem and to segregated geographical areas where the problem has surfaced. What is clear is that the solutions should not be limited to insurance. What is needed in nearly every such troubled line is a stable business and legal environment. What is required to achieve that varies by the nature of the underlying problem.

We of the property/casualty insurance industry are working with insurance departments and affected businesses and individuals in all of those states where problems have been identified. We are not in the business of not providing insurance. It is in our interest to do so and it is right as a matter of sound public policy that we do so.

We appreciate the opportunity to address the issues of concern to this Subcommittee, and want to work with you and the individual states to solve these difficult issues of availability, and affordability of liability insurance.

[The following information was subsequently received for the record:]

QUESTIONS OF SENATOR PRESSLER AND THE ANSWERS

Question. How do you set rates in specific states?

Answer. Insurance industry rates are determined by a variety of factors, including past loss experience and expected future losses. They are generally determined on a line-by-line state-by-state basis, in accordance with the statutory rating law that exists in the particular jurisdiction. In South Dakota, for example, the law requires the prior approval of rates and forms by the Director of Insurance. There are some exceptions to the general rule of prior approval, and they are contained in Section 58-24-10. If possible, rates are based on a state-by-state basis. Every attempt is made to base rates on the true loss characteristics of the class. An example involving automobile insurance illustrates the point. Individual rating territories are assigned based on actual loss experience. The people of Miami, Florida, pay more for automobile insurance than do the people in the state capitol of Tallahassee. In automobile insurance, there are a sufficient number of units to make credible rates.

The charge that rates for municipal liability are not based on actuarial experience is false. The claims climate and underlying tort system do play a significant role in determining whether a company actively seeks to write a particular line of insurance.

In the case of South Dakota, as in other states, sovereign immunity was once a defense for local governments. Despite a conservative judicial climate, in comparison with other states, there are no caps on municipal liabiltiy (South Dakota Codified Laws, Sections 21-32-1 and 9-24-1 et seq.). Lawsuits against municipalities are increasing countrywide. In New York State, according to a report entitled "Deep Pockets a Study of Municipal Tort Liability, " at the end of 1983 where were 11,296 tort actions pending against local governments (excluding New York City), in which plaintiffs sought damages totaling $25.8 billion.

The experience on both a country wide basis and individual state characteristics are a part of the risk assessment process. Different states have different characteristics. We are told that South Dakota has a large number of Earthern dams. This would present a different hazard than an area of the country that had different characteristics. As mentioned earlier, South Dakota has no caps on liability. The State of Wyoming has a limit on liability for state and political subdivisions of $500,000 (W.S.A. 1-34-118).

The problems of South Dakota are different than those of New York. According to a recent study by The Wyatt Company, the north central region of the U.S. had the lowest average severity of losses (less than $15,000 per loss). The western portion of the U.S. had averaged losses exceeding $35,000. Both regions have problems, with the western states simply having a greater problem. Attention is given to individual states, although the specific problem in municipal liability is countrywide.

In summary, rates are set on a by-line, by-state basis. In the area of commerical liability, individual data is used to the extent possible to produce credible rates. Sometimes this involves the use of country wide data. The experience of the industry across the country in municipal liability has been growing more severe for the last five years. There is nothing to suggest any significant improvement in the loss experience at the present time.

Question. What is the relationship between liability insurance rates and the tort laws in particular states?

Answer. The tort system and claims climate play a significant role in a company's decision whether it will write a particular line of business in a particular state, and what rates it will charge. For example, reinsurers recently excluded coverage for pollution risks in Minnesota because state law imposed an extremely onerous form of strict liability upon insureds. It is not possible at this time to state specific percentages of claims paid as a result of court awards or court awards as a percentage of premiums, although a number of industry studies are underway that will summa-

rize similar data. We do know, however, that significant adverse changes in a state's tort law will make insurers less likely to write affected lines in that state, because costs will be higher and because the lack of predictability of future costs may make certain types of claims virtually uninsurable (for example, how does a products liabiltiy insurer assess the risk presented by California or New York pharmaceutical manufacturers that are subject to liability under a "market share" (*Sindell* v. *Abbott Labs.*, California Supreme Court, 1980) or "concert of action" (*Bichler* v. *Eli Lilly*, New York Court of Appeals, 1982) theory of liability *without proof that they manufactured a product that caused injury?).* The industry continues to develop more data in this area, and we will submit it to you when available.

Question. What was Utica Mutual's reasoning behind its decision not to provide municipal liability insurance in New York State?

Answer. In the words of Thomas P. Bonaros, Vice President-General Counsel of Utica, before a New York Senate Committee:

"Our experience with municipal liability has been described in a single word—disastrous. The two-word reason is loss ratio. A 200+% loss ratio for the general liability exposure for the last two years, coupled with the view that things would get worse, rather than better, suggested that for our company, given our financial resources, the only responsible course of action was an orderly withdrawal from this market. . .

"What has happened to bring us to these circumstances? Historically, municipalities and their corporations were protected from lawsuits under the doctrine of sovereign immunity. They were held immune from liability in the performance of their governmental functions, unless otherwise provided by statute. Today, the erosion of this doctrine has become almost complete. Where once 'The King could do no wrong', it appears that he can now do almost nothing right. . .

"A sampling of recent cases shows the kinds of exposures municipal governments face in their day-to-day operations:

"A police department's height requirement as applied to women is ruled discriminatory.

"A suit for millions is brought by an individual who alleges excessive force was used when he was arrested by the village police.

"A car crosses the center of the road and hits an oncoming car. Injured plaintiffs allege that the county improperly posted, designed and maintained the road.

"Two vehicles collide at an intersection; one driver is ticketed. The town is sued when one of the parties alleges improper road warnings and road construction.

"A tree limb falls onto a convertible passing underneath. The driver is paralyzed and sues the town for improper maintenance.

"And there are claims arising out of horseplay on town beaches, jail suicides and failure to enforce fire codes. We could go on and on."

Utica's *total* combined ratio (losses and expenses/premiums) for class A New York municipalities soared from 124.02% in 1980 to 145.9% in 1984—$1.46 paid out for every $1.00 in premiums taken in. For class B New York municipalities, the combined ratio was 153.7% in 1984. These figures include the over-200% loss ratios in municipal general liability to which Bonaros referred. Appendix I contains Utica's data.

Question. How effective is risk management in making a municipality more attractive to an insurance company?

Answer. Proper risk management can certainly make a municipality a more attractive risk for an insurer. To some extent, as mentioned above, municipal risks are individually rated, and a good loss record will certainly help lower a municipality's rate. The fundamental problems in this area lie far deeper, however, and municipal liability coverage is unlikely to become significantly more available in the short run until insurers are able to reverse the trend of the last five years and return to something approaching reasonable profitability. In the long run, tort reform is desperately needed, to allow companies to predict and underwrite these risks. Good risk management will certainly help, but it is not a panacea.

Question. Is there a federal role in solving these problems?

Answer. Federal action is needed to unify and make rational the product liability law of the United States, because manufacturers in interstate commerce need far more certainty than the current chaotic state of the law gives. Beyond this, however, we believe that the fundamental role in insurance regulation must continue to be at the state level, where regulators have the necessary insurance expertise and are closer both to the companies they regulate and the policyholders whose interests they protect.

Question. What specific actions can the state and federal governments take?

Answer. On the federal level, the Congress must reform product liability law, which has simply gotten out of hand at the state level. Such a reform should at least:

(a) Provide uniform liability rules and defenses, so that the law does not change capriciously from state to state;

(b) Allow defenses based upon compliance with the state of the art, product compliance with government standards and alterations by third parties;

(c) Eliminate or limit punitive damages;

(d) Regulate attorneys' contingent fees; and

(e) Provide a reasonable statute of limitation.

S. 100 and Senate Commerce Committee Staff Working Draft No. 2 address many of these and other concerns.

Most of the actions necessary to make municipal liability insurance more available and affordable, however, must be taken at the state level. These actions include:

(a) The establishment and use of *voluntary market assistance programs* and *surplus lines clearinghouses* to direct local governments to insurers that are able to provide them with coverage;

(b) The approval of the Insurance Services Office's new *commercial general liability policy,* providing coverage on a claims-made basis. This will give greater certainty in determining the coverage period and avoid costly litigation over policy application;

(c) Encouragement of *group self-insurance,* to add capacity to the municipal liability marketplace until improved industry financial condition and fundamental tort reform make this line profitable to write; and

(d) *General tort reform* at the state level, including these changes:

1. Reinstitution of the doctrine of *sovereign immunity* for certain defined governmental activities, along with a reasonable cap on awards;

2. Adoption of the doctrine of *several liability,* making each defendant liable for the harm it alone causes, replacing *joint and several liability,* which makes a marginally responsible defendant liable for *all* harm cause by *all* defendants;

3. Elimination or limitation of *punitive damages,* a penal concept inappropriate in a civil liability system;

4. Provision of a *state of the art* defense, assuring that manufacturers and professionals (city planners, street and highway designers) are judged by the professional standards in effect at the time of their actions;

5. ceilings on *non-economic damages,* such as pain and suffering;

6. reform of *contingent fees,* including the use of a mandatory sliding-scale fee system, and

7. encouragement of the use of *alternative dispute resolution* methods.

Question. Will tort reform lower insurance premiums?

Answer. Insurance premiums will certainly be lower if tort reforms are mandated than they will be if such reforms are not enacted. (It is is significant here that, on an inflation-adjusted basis, 1984 commercial insurance premiums were *significantly lower* than they were in 1978.) It is difficult to quantify the exact effect of future tort reforms on premiums. But several studies indicate that they will be effective in reducing the costs of the civil justice system, which will reduce the costs that insurer must bear.

STUDIES OF THE IMPACT OF PREVIOUS REFORMS

The most significant research on the results of medical malpractice tort reforms has been done by Patricia Danzon, of the Institute for Civil Justice and the University of Pennsylvania. In her 1983 work, "The Frequency and Severity of Medical Malpractice Claims," Danzon analyzed the effect of a number of reforms on claim frequency, claim severity, and total claim cost. She found the following results. Caps on awards, usually caps on the noneconomic portion of damages, had a significant impact on claim severity, or average claim size. Her study was able to show that states which adopted caps on awards had, on average, 19% lower claim severity two years after adoption. This does not mean that each state experienced this reduction; rather, this was the average impact across all states. She also found that the mandatory offset of collateral sources reduced claim severity, on average, by 50% over two years. Several additional results from the Danzon study were that the elimination of the plaintiff's Ad Damnum appeared to reduce total claim cost and increasing the length of the statute of limitations appeared to increase claim severity.

A second, more recent, study by Danzon examined a closed claim data base from a major malpractice insurer. While this database cannot be regarded as comprehensive or even necessarily as representative of the general malpractice market, the results provided are suggestive. Danzon found that caps on awards again appeared to be significant in reducing average awards. The offset of collateral sources, either a mandatory offset or simply the presentation of evidence of collateral payments, appeared significant in reducing average awards. This is a change from the earlier Danzon study which found a significant impact only from the mandatory offset and no impact at all from the introduction of evidence alone. Danzon also found that increases in the length of the statute of limitations increased the frequency of claims, while the voluntary use of pre-trial screening panels raised the average claim level (which would be expected if the panels "screened" out the weakest cases). The use of arbitration mechanisms reduced the average size of claims, but appeared to increase the frequency of claims, resulting in an uncertain impact on the total cost of claims.

ESTIMATES ON THE IMPACT OF FUTURE REFORMS

In addition to the studies of the effects of past tort reforms, there have been several studies which estimate the future cost effects of adopting various medical malpractice reforms. During 1983, Tillinghast, Nelson and Warren and Peat, Marwick estimated the potential savings in malpractice losses, if certain tort reforms were adopted in New York state. Both studies focused on the potential savings from a package of malpractice reforms under consideration then. Because the package was not adopted at the time, no further study has been possible testing the predictions made. Although both studies made strong predictions, Tillinghast prefaced its results with a warning that the lack of "meaningful data" means that the actual cost savings from the reforms ". . . could be significantly greater or less than the savings estimated."

The reforms which were considered included: regional review and discipline boards for physicians, panel bonds and certificates of merit for a malpractice case filing, establishment of criteria for expert witnesses, limitation of non-economic losses to $100,000, structured awards for judgements in excess of $100,000, and a sliding scale limit on contingent fees. Tillinghast estimated the reduction in malpractice losses to be about 15%–20% from the limit on non-economic damages awards. A limit on contingent fees would save about 10%–15% in malpractice losses. A much smaller potential savings (.5%–1%) was estimated from the panel bond and certificate of merit. From the other reforms, Tillinghast predicted no measurable cost savings. In making its predictions, Tillinghast was very careful to distinguish between loss savings and premium reduction: ". . . the indicated loss reductions will not cause a reduction in the current rate level. Since the current rate level is deficient, this savings will only decrease the amount of the deficiency and the amount by which rates need to be increased."

Peat, Marwick's analysis also predicted savings in projected losses and expenses from various reforms. From the panel bonds, they predicted a .7% savings. From certificates of merit, they predicted a .2% savings. The limitation of non-economic damages to $100,000 would result in a 25% savings, according to Peat, Marwick. The sliding scale limit on contingent fees would result in an approximate cost savings of 10%, according to these predictions. A provision for structured awards was predicted to have no measurable impact on costs.

In addition to these 1983 studies, the New York Medical Society recently commissioned another analysis of the cost savings from a $250,000 limit on non-economic damages in medical malpractice cases. This study was prepared by an actuarial consulting firm, Future Cost Analysts. The FCA study compared the experience in California following the adoption of such a limit to the malpractice experience in New York. Based on this analysis, FCA predicted a reduction of 20% in the current medical malpractice liability premiums charged in New York.

THE CONSENSUS FROM THE STUDIES

The most comprehensive and rigorous studies of the impact of tort reform appear to be those done by Danzon regarding medical malpractice reform. From those studies, she concluded that caps on awards, the offset of collateral sources (mandatory offsets and possibly the introduction of evidence alone), and the elimination of the plaintiff's Ad Damnum did reduce the severity of malpractice awards.

The three actuarial "predictive" analyses all predicted a large savings from the adoption of caps on noneconomic damages, possibly as much as 25%. In addition, the two 1983 pieces predicted savings from sliding-scale limits on contingent fees of about 10%–15%.

Senator PRESSLER. Thank you. Mr. Quinn.

Mr. QUINN. Thank you. I am Mayor Gerard Quinn, mayor of Sharpsburg, MD, district vice president of the Maryland Municipal League. I am here today representing the National League of Cities and the 15,000 direct and indirect members. I wish to thank the Chairman and members of the subcommittee for this opportunity to come before you to discuss the current crisis confronting municipal governments of all shapes and sizes.

Cities are being forced to reduce the services for which insurance coverage has either been reduced or for which there is no longer coverage available. Other cities with no choice other than shutting down services altogether have been forced to do the unthinkable, and that is to go bare, without any insurance whatsoever.

While cities everywhere grapple with the immediate short-term question of where to get insurance or how to be able to afford it, the larger question remains on how the long-term solution to what is expected to be a recurring problem. Agreement upon such a long-term solution might be, and what role, if any, Congress and the administration must take toward the resolution of this crisis requires as fundamental understanding of why cities everywhere have been so severely and unequitably affected.

Problems in obtaining and affording municipal liability insurance in many cities throughout Maryland are clearly representative of both the severity and the magnitude of the disaster which has hit upon nearly every city in America.

Frederick, Denton, North Beach, Elkton, and Chevy Chase Village recently received liability insurance cancellations. A similar cancellation in Sikesville we are all familiar with because it hit the national news. And the cancellation of insurance in Bladensburg resulted in their not having a police department, period. They were ordered off the street.

Chestertown experienced a 250 percent increase in excess liability. Cumberland, a 100 percent increase in auto liability. Baltimore, a 500 percent increase in property liability. Gaithersburg, 593 percent increase in excess liability. Westminster, 130 percent increase. Salisbury, a 220 percent increase in auto liability.

A city cannot find any for pollution coverage. Similar market problems are evident not only in Maryland but in the rest of the country as well. This is merely a sample indicating the problem, but it reflects the choice of most local governments. When presented with cost increases of the magnitude mentioned above, it is either higher taxes, reduced service, or go without the coverage.

Now, in reference to the Federal problem that we are discussing here today with authority to regulate the insurance industry having been left to the states, Federal intervention in the crisis has been slow in coming. One option for such Federal intervention is the Federal reinsurance plan for certain lines of insurance that companies are refusing to write at this time. While we wait for Congress and the administration to agree upon their role in intervening in this crisis, confronting municipal governments, cities have had to turn to States and even to themselves for resolutions to this problem.

Such a course of action is usually limited to prospects for either pooling, which is joint self-insurance, or individual municipal self-insurance. Obviously, the size of the municipality decides which direction you can even consider. Pooling offers smaller communities an opportunity to become involved in self-insurance or self-funding, something which they might not be able to do on their own.

Today there are between 160 and 175 intergovernmental pools operating in 25 states. Combined membership in these pools totals at least 15,000 public entities. Self-insurance is also a growing option among a number of larger cities. Such self-insurance usually takes the form of an earmark contingency fund with its own line item in the municipal budget in the event of liability damages being awarded.

Self-insurance, however, is not a universal option to cities of every size. While pooling and self-insurance are both immediate and viable short-term responses to the current municipal insurance crisis, they are simply that, a short-term. Many State and Federal regulators and lawmakers believe that the only real long-term solution is revising the system of liability law to limit damages. While tort reform is supported by insurers and opposed by consumers and lawyers because it would limit liability awards, such wholesale tort reform either at the State or Federal level could include efforts to eliminate punitive damages in most litigation, limit the use of contingency fee arrangements, and limit the doctrine of joint and several liability.

It could also seek to establish caps on the amount of damages awarded against municipal governments. Currently 28 States already have these types of caps, and many are actively seeking passage this coming year. While the State damage award caps will not provide relief at the Federal level, they may be the first step in protecting the taxpayers' dollars against high damage awards. With such caps on liability, local governments would be able to more accurately predict their losses and use this information to continue to become more independent of the insurance market.

In conclusion, the soaring costs and unavailability of liability insurance coverage strikes at the very heart of municipal services, and jeopardizes the continuing provision of essential health and public protective services. It is crucial that the Federal, State, and municipal governments work together to position themselves to cope throughout both the current hard sellers market and the next that will be following certainly.

We urge Congress and the appropriate Federal agencies to investigate this situation and to study the options in cooperation with the States to see if any adjustments in Federal statutes or regulatory rules are deemed in the public interest.

I thank the subcommittee for this opportunity to present our concerns to you. We appreciate the difficult task before you as you, too, try to confront this crisis, and we trust that the needs and concerns of the American cities will be heard.

Now, aside from my prepared text, I would like to add that I am presently serving on the Maryland Governor's Task Force on Liability Insurance, and representing both the league and my small municipality. One thing that we must remind everyone is that it is the taxpayer who may receive the verdict, but it is his fellow taxpayers that are going to pay for that verdict in their insurance costs and in their tax rates.

An example of how this affects you quite simply is the small town of Sharpsburg, approximately 825 people, annual expenditures, depending upon how it goes that year, is between $30,000 to $45,000. At the present time simple liability insurance to cover the mayor and counsel and the planning and zoning commission takes about 10, 8 to 10 percent of that insurance, that total budget. That is how it affects the municipalities that are out there in the day to day contact with people.

And one other point I wish to make, if I can take another second, is, you wonder why the Federal Government should be involved. The Federal Government passes down guidelines to States and municipalities. These we must follow, and an example of this is the town of Sharpsburg, in order to receive Federal funding or Federal grants, had to adopt planning and zoning. We adopted this. We passed it. We set up the appropriate boards. One taxpayer becomes irate with the decision. That matter is now one of three that sits before the Federal court in this country. To date, without getting past a summary judgment, we have spent $19,000 plus in legal fees.

This is over a matter of one zoning decision. These are things that are passed down from the Federal Government to the local municipality, and it has a tremendous effect.

Thank you, gentlemen.

Senator PRESSLER. Thank you very much.

Mr. Ferraro.

Mr. FERRARO. Mr. Chairman, distinguished members of the Committee, my name is Mark Ferraro. I am the risk manager of Dallas, TX. I also serve as the vice president of the Public Risk Insurance Management Association, known as PRIMA. We are the counterpart to RIMS. PRIMA is an association for risk managers from a broad spectrum of public entities, these including general purpose governments such as states, counties, and cities and special districts like schools, transportation, and housing authorities.

Before you, you should have a prepared text of our written statement, and what I would like to do is digress a moment and just hit the highlights of our testimony.

Senator PRESSLER. Yes, we will put your entire statement in the record.

Mr. FERRARO. PRIMA agrees that there is some need for tort reform, but we reject completely the idea that tort reform is driving the current problems with liability insurance. Like any system, there are some improvements that can be made to the current tort system. Specifically in the area of barring recovery for punitive damages, allowing only for economic recoveries in tort actions, and placing a limit on pain and suffering.

We also believe it would be very important to disclose in a trial the contingency fee arrangements, not that they should be barred, but they should be disclosed to the judge and jury, so that the judge and the jury understand that the dynamis of the economic replacement that they are trying to achieve. How that money is divided up, and how much goes to the plaintiff, how much goes to the attorney, and how much is being eaten up by court fees is germian to the issue at hand.

Joint and several liability laws in several States in this nation really serve no realistic purpose other than they create a deep pocket for local governments and these laws should be appealed. It doesn't take very much to show at least 1 percent negligence on the part of the local government in road design or signage or traffic control and other such issues.

We would like to see that most tort claims or all tort claims go through binding arbitration or some system of mediation before the tort is allowed into the court system. In large awards, there be a mandatory structure settlement for both the plaintiff's award and for the plaintiff's attorneys' fees. We feel that the lack of structured settlements is a driving issue behind large awards.

Governmental immunity is an issue, as other speakers have spoken on in this panel and other panels. There are many services that local governments are mandated to provide. We cannot withdraw from providing police protection. We cannot withdraw from providing fire protection. In many States our jurisdictions are required to provide public health, whether it is wellness programs or acute care facilities.

We have no other option but to provide those services. So on the one hand we either need some type of statute that limits our liability, I think commonly referred to as sovereign immunity, or we need a mechanism to provide liability insurance. Finally PRIMA is very concerned about the new programs being offered by the insurance industry as a solution to the current crisis, primarily the claims made form.

We have had previously many eloquent speakers talking about the pros and cons, but to government we do not see this as a solution. First of all, very few governments have latent defects. Our problems are most immediate, and we do not see how a problem which is being created by latent defects such as asbestos, pollution, and other long development problems is going to resolve the pricing issue currently affecting municipal entities.

And finally, I think Congress' role could be to develop a national policy on social issues. It is a little but unfair for local governments to have to respond to tort claims which arise out of social policy actions or issues that the governments again are forced to provide or forced to deal with. That concludes my remarks.

[The statement follows:]

STATEMENT OF MARK FERRARO, RISK MANAGER, CITY OF DALLAS, TX, ON BEHALF OF THE PUBLIC RISK AND INSURANCE MANAGEMENT ASSOCIATION

Mr. Chairman and distinguished members of the committee, my name is Mark Ferraro and I am the risk Manager of Dallas, Texas. I also serve as a vice president of the Public Risk and Insurance Management Association, known as PRIMA. PRIMA is the association for risk managers from a broad spectrum of public agencies including general purpose governments such as states, counties and cities, and special districts like schools and housing authorities. We represent approximately 5,000 different agencies.

I appreciate the opportunity to appear before this committee on behalf of government risk managers. We are on the front lines and deal with liability issues on a daily basis. It is crucial that Congress hear from those of us serving at the other levels of government about the particular problems that we face and I thank you for asking us to participate in these hearings today.

Governments at all levels—federal, state and local—have been created to carry out certain functions that our citizens deem necessary for their health and well-being. These include activities that society feels should not be carried out by the private sector or, as is often the case, no one else wants to do. The federal government does not have much of a choice about whether or not it fields an army. Likewise, a city does not have much say in whether or not it puts a police force on the streets. This is the business of government. This is our mandate, our responsibility, our reason for existing: to serve our citizens. Neither the federal government, nor state government, nor local government has the option to leave the marketplace as can a private firm.

But, while all of us on the different levels of government have been charged with various responsibilities by our taxpayers, state and local governments have an added burden to carry: the erosion of sovereign immunity over the past decade. So while we are all required to perform risky functions on behalf of our citizens, there is now an important difference between the federal government and the other levels: those of us in the states and localities are more exposed to suit. This means that we now have to adequately cover ourselves through insurance or alternative funding strategies.

State and local governments are facing a major financial crisis as a result of the insurance industry's sudden departure from the municipal market. We know of some small local governments that have closed up shop, disincorporated because of the specter of liability exposure without commercial insurance to protect the community and its officials from suit. Mayors and councils have resigned as a result of not being able to obtain insurance to protect the appointed and elected officials of these jurisdictions. Police patrols have been pulled off the street because of insurance company cancellations or nonrenewal of policies. School busses are sitting empty in the schoolyard because the system has lost its coverage for the school bus fleet.

In a clean sweep across the country, the insurance industry is withdrawing from the municipal market. Those who are not cancelled are faced with incredible increases in premium, some as much as 1,000% higher than the prior year's premium and often with lesser coverages, lower limits of liability and higher deductibles. The entity is being asked to retain much more of the risk and at a much greater premium.

As risk manager for the City of Dallas, I speak of these problems from first hand knowledge. The City of Dallas is one of the public agencies in this country that has been forced to go bare (carry no insurance at all) because of the incredible price tag placed on its insurance package. Prior to May 1, 1985, Dallas was self-insured for the first $2 million of each occurrence and purchased excess insurance to limits of $50 million. For the past five years, the city has settled every claim within the retention level—our insurance company never had to settle or defend any claim during this time because the excess layer was never pierced. In May 1985, when the city tried to renew coverage, we were hit with a 958% increase in premiums—meaning that the actual premium cost jumped from $157,000 to $1.5 million. In addition, the current carrier which had been the lead underwriter for five years could not guarantee previous limits of $50 million—in fact, the highest limits we could be assured of were $5 million. This was happening to a city that had never asked the insurance carrier for a penny in defense or settlement costs. Dallas has a national reputation as a well-run city with a highly trained police force. Certainly court costs were under control and claims were not exorbitant. In addition, Dallas has had for many years a fully functioning risk management program overseeing and anticipating any liability problems that might develop.

Since buying $5 million of insurance coverage for $1.5 million was completely unacceptable to the city of Dallas, the decision was made to go bare. This leaves the city exposed to a possible catastrophic loss. Even a city with the financial strength of Dallas needs the ability to transfer the risk of catastrophic losses to an insurance company.

Dallas is just one of the public agencies in this country that has been faced with insurance cancellations, nonrenewals or excessive premium costs. Some agencies have purchased insurance at any price because of the fear of being caught short and having to go back and assess taxpayers. A recent local government liability survey conducted by PRIMA revealed that the average premium increase for general liability coverage was 150% with a high of 630%. One respondent reported that the premium for umbrella coverage increased 1500%—from $5,500 to $88,000. Average umbrella increases were 395%.

Half of the survey respondents reported that their liability insurance was not renewed by the same carrier. The survey also revealed that many public entities have been forced to self-insure their liability exposure as a result of the insurance crisis.

Why is this happening? It has little to do with the experience of the particular entity that is being cancelled or hit with enormous premium increases. Good and bad risks are suffering. It is a perception of the insurance industry that governments are not good risks—any government—even those that have not suffered a loss of any consequence in all the time that they were underwritten by a particular company. Contrary to popular thought, the insurance industry does not take risks; to spreads them. In hard times, the industry prefers to write only those areas which are not risky. Municipalities, counties, school districts, highway authorities, etc. are perceived as risky by the industry; thus policies have either been cancelled, not renewed or increased so drastically in price that the coverage is in all actuality not available or affordable. By its actions, the industry is sending governments a clear message—it does not want to write any type of government business.

The insurance market is cyclical. The last down cycle was in the mid-70's, also a period when local government found it very difficult to obtain insurance. Then the economy shifted; interest rates were as high as 20 percent. Money was being invested into the market. To increase their cash flow, companies engaged in what is called "cash flow underwriting." Competitive pricing resulted in premiums falling far below realistic levels so that more money could be infused into insurance companies. As interest rates plummeted in 1983 and 1984, the industry's underwriting losses were no longer offset by investment income and many companies began experiencing financial problems.

To compensate for these financial problems, insurance companies pulled out of the municipal market claiming that they will not return until the civil justice system in this country is changed and local government is no longer the deep pocket of every Tom, Dick, and Harry. The industry gave this exact reason for pulling out of the hard market of the 70's. It was said that the industry would not write government business until changes were made in the civil justice system. However, because of the cyclical nature of the insurance, industry, companies again returned to write governments in the early 80's, pricing their products far below market value an setting the stage for the financial problems that exist today.

Government is not the only group that is suffering during this market crisis, but govenments are unique in that they exist on taxpayer dollars, operating in the public interest and by custom or statute required to provide such unprofitable and risky services as police and fire. Because of their taxing authority, governments are viewed by both plaintiff and trial attorney as the ultimate deep pocket to cure all their ills.

Local and state governments face two threats from the Civil Justice System—one under state law and the other from federal litigation brought under the Civil Rights Code of 1871. State tort liability has become an enormous problem in the past decade since the abrogation of sovereign immunity totally or partially in most of the states. Some states still retain some vestige of sovereign immunity, but the propenisity of claims has increased dramatically. At least 28 states have sought remedy by limiting the amount of award that can be granted in liability cases. However, to circumvent the state tort system, attorneys will attempt to claim a civil rights violation and have these cases heard in federal court where the sky is the limit.

Action is needed for tort reform. Governments are attempting to become more independent of the fluctuations in the insurance market and fund their own risks. We in local government are taking the initiative in trying to protect taxpayers against catastrophic losses, i.e., the dollar amount of thes losses. We are strengthening risk management programs, creating innovative self-funding mechanisms, and banding together to jointly finance risk through statewide intergovernmental pools. Howev-

er, even though we are trying to take the initiative, there are often roadblocks. For example, enabling legislation for local governments to create a risk sharing pool is often blocked at the state level by special interest groups. We advocate that local governments be allowed to pool their risks at the state level. This has worked since the first pools were established in the 70's during the last hard market.

To effectively manage risk, predict losses over a period of time, and establish sound loss funds, local governments need the certainty that can be afforded by reforms in our civil justice system.

One area of major concern to state and local governments is that of joint and several liability laws which pay the taxpayers perceived deep pocket. In many states, if one of the defendants a suit is found to have a little as 1 percent responsibility for a claim, that defendent can de made to pay 100 percent of the judgment if the other individuals or organizations involved are unable to cover their portions of the damages. Government, as the deep pocket is the organization that usually is still there to receive the brunt of joint an several laws.

Another issue of great concern to local governments is that of contingency attorneys fees, both at the state and federal level. Contingency fee arrangements are counter productive in that they fail to deliver just compensation to the plaintiff. How would juries react if they could see entered into evidence exactly how an award is going to be parceled out between a plaintiff and his or her attorney? We suggest that juries be made aware of the fact that there are three parts to an award: the plaintiff's award, the attorney's fees and the court costs.

The awarding of punitive damage is another serious problem. Punitive damages have not place in these types of awards and should be stricken from civil actions against state and local governments.

In discussions on tort liability caps, attention should be given to limiting economic damages, and placing limits on awards given for pain and suffering.

There are other possibilities for reducing the liability burden on state and local governments. For example, mediation and arbitration are two techniques that should be encouraged by the court system. Also, mandatory structured settlements on awards over a certain limit could relieve the financial burden often faced by state and local governments and still justly compensate the injured parties.

State and local governments can not serve as the universal deep pocket for plaintiff and trial attorneys and fund damage suits with questionable validity and unrealistic awards. The crisis in the insurance market limits governments ability to pay and targets the taxpayer as the last resort for damage awards that may carry a jurisdiction to the brink of bankruptcy. Changes in the tort system at both the state and federal level, more uniform legislative oversight for regulating insurance, and increased emphasis on managing risk in a systematic and well-planned manner will provide the opportunity for governments to create their own risk funding alternatives and become more independent of the dips and swings in the insurance market.

Senator PRESSLER. Thank you very much.

I want to thank this panel. I think the things you have said have brought it home, especially the mayor's testimony about the effect of the insurance problem at the local level. I do have quite a number of questions to submit for the record.

I would ask just one of my questions to the panel, and then I will place the rest in writing.

You cite, as have other insurance industry representatives—this question is for Mr. Farmer—here today figures which document the proliferation of civil suits and the growth of court awards in these suits.

Can the insurance industry give us a clear picture of the role of the insurer in paying the civil awards? Specifically, what part of the claims the insurance industry paid out in recent years were awards in civil suits, and what part were uncontested claims? And you may want to answer that in writing.

Mr. FARMER. Senator, I think some of that material is filed with the State Insurance Departments. We are going through a second stage in terms of the liability crisis. Ten years ago we had problems in product liability and malpractice. In response to that, State legislatures, insurance commissioners required additional detailed data, and we will provide that data that is in the annual statement in addition.

Senator PRESSLER. Yes, and I ask that as a long-term friend of the insurance industry. I do think we need additional data so we can determine to what extent this is a torts claim problem and a court problem, but I think it would be good for all of us if we get a clearer picture, but I thank you.

Senator Rockefeller.

Senator ROCKEFELLER. Mr. Chairman, just one statement and one question to Mayor Ashley, who I did not have a chance to introduce. Mayor Ashley, Mr. Chairman, has been mayor of Nitro for some time and is considered to be one of West Virginia's best mayors ever. He is the president of the West Virginia Municipal League.

Mayor Ashley could be doing a lot of other things in life, and here he is giving testimony suggesting that if liability insurance is cut off to the city, that he may resign before the end of his term. He may have no choice, and that makes me, in turn, reflect on mayors in smaller communities. I do not know what Mayor Ashley's salary is, but I do know that in a number of smaller communities in West Virginia the mayor's salary might be $100 per month or it might be $200 a month. There are people who serve the public because, as Mayor Ashley said, they have a fundamental belief that local government and the whole democratic process is learned most clearly at the local level. Local government is the closest thing to government at its best.

You do not have hearings at local levels. We do not sit around big mahogany tables like this and listen to testimony. You have to solve problems. You are on the spot. Some people say, is there not a way that we can give different kinds of education training to police officers, to fire chiefs, and to mayors to help municipalities keep their insurance rate's down. But that won't solve the problem.

The kind of life that you lead, the kinds of decisions you have to make, the kind of on the spot decisions that the police officers have to make, fire people have to make, does not allow for situational education. These are high pressure positions, and yet people are personally liable. I am not sure everybody understands that in this country. I think a lot of people when they think about bringing a lawsuit against a public official they think it is just against the person as a public person.

It can also be against the person as a private person. For example, the mayor of Nitro could be sued not only in his capacity as a mayor but in his capacity as an individual citizen of the United states. Perhaps the mayor has some kids in college, things he has to pay for, debts he has to pay, and yet he has no recourse. I find it incredible and yet entirely understandable what Mayor Ashley has said—that if liability insurance runs out for his city, he is not going to be there. I do not blame him and I wonder when you mention Taylor County or Grafton

whether the public officials there want to resign. I wonder how many mayors, how many county commissioners, how many parks and recreation employees, how many police chiefs right now are thinking about whether they want to serve out their term. Do we understand the consequences of that kind of thinking? It is not the fault of the mayor. It is not the fault of the police chiefs. It is the fault of this kind of insidious system.

The insurance companies say that the reason we are facing this insurance predicament is they just could not predict very well. Everybody else says we should change this and change that. I said in my opening testimony that I wasn't sure what the answer was. I am not sure what the States are meant to do. I am not sure if there is the money for all of this.

Ordinarily in business if an insurance company or some other business cannot make it, they go out of business. And perhaps insurance businesses are going out of business. However if the Congress and States ignore this problem and people like Mayor Ashley have to leave office either due to a decision not to run again or a decision to leave office before the end of their term then this country is in very serious shape.

I am really glad that you are here today, Mayor Ashley. You are the only person who has said in the course of all of this testimony that if you are faced with a lack of liability insurance, you will not be able to be in office. You are not poor. You are not rich. You are an average, very intelligent working person who decided to be mayor because you care about that important city in the Kanawha Valley.

Now, if you leave office, and if others are forced to follow suit I think this country is in a severe crisis. I cannot tell you, Mr. Chairman, how strongly I feel about that. All of us in public life have been sued. I have been sued. You get sued as governor. You get sued as mayor. You get sued as county commissioner. You not only get sued as a public person, you get sued as a private person. When you get sued as a private person, then the insurance company may or may not take up your case. If they do not take up your case, then you have got to pay for it yourself. You have got a couple of kids in college. You cannot afford to pay for it yourself, so what do you do, settle? If you settle, then you are considered to be guilty. So what are you going to do? It is a tremendous crisis for this country.

I admire people like you, Mayor Ashley and you other gentlemen, mayors who go through this day in and day out. One little mishap of the police department or the fire department or some discourtesy that you might make in a moment of peak to somebody and you find yourself sued, and then you are at risk, naked, or bare, as the official term is. Naked would be more like it.

I guess that is my statement, Mr. Chairman. I think it has also been brought out this morning and this afternoon that the tourism industry is at risk. In West Virginia, tourism is the second largest industry in the state, number two. It employs 25,000 people in the state.

And at this hearing we heard that the tourism industry is in jeopardy because of this insurance, liability insurance problem.

I have a new sense of respect for you as mayors, county commissioners, and other public officials at the local level, who go through what you do, relatively unprotected. And I do not ask you to make comment on it.

Art, I have known you a long time and I have never known you to be so silent for so long.

I just find it a matter of real goodness that you serve, and I hope that you will continue to serve. And I hope that the liability insurance will stay there, because when you have to make tough decisions sometimes you get tough responses.

Do you want to make a comment on that? I really did not ask for one. I just gave a speech.

Mr. ASHLEY. Well, Senator, I would like to say one thing in response to your comment. I think if the mayors or the city officials, if local governments throughout this country were completely candid with everyone, they would first of all admit the crisis exists. I think they could all tell you personally about people that they know who have declined to serve or plan to drop down from service because of this problem.

If it does not affect them personally, it affects someone they know and work with. That would be my expectation throughout the land.

Senator ROCKEFELLER. I thank the chairman.

Senator PRESSLER. Thank you very much.

Mr. Farmer.

Mr. FARMER. Mr. Chairman, if I could just respond just briefly that the legislature in West Virginia and in South Dakota in the upcoming session can restore sovereign immunity or some immunity for these public officials, or can cap the liability that they will be held responsible for, and that certainly would be a step in the right direction.

Senator PRESSLER. Mr. Ferraro, do you have a brief final statement?

Mr. FERRARO. I would like to make a brief statement to rebut Mr. Farmer's statement. In 28 States and Texas there are similar laws like that as advocated by Mr. Farmer and insurance industry. In Texas it is called the Texas Tort Claims Act. And it has done nothing to improve the availability of insurance or reduce the price of insurance in our State or other states.. So I do not believe that, even with those laws, insurance companies will write liability insurance for municipalies.

Senator ROCKEFELLER. Do you mean a cap has not in any way brought down the cost of insurance?

Mr. FERRARO. No, sir.

Senator ROCKEFELLER. That sounds like the subject of another hearing, Mr. Chairman.

Senator PRESSLER. Well, Senator Danforth has told me that he will be holding further hearings next year and will make this—I think we all should make this a major issue, because I think it is one of the chief issues I hear about, and I think it is the leading consumer issue of the 1980's and 1990's.

I want to thank Bob Samors for his work in preparing a lot of the materials for this hearing, and other members of the staff. I want to thank all of the witnesses, and I want to thank Senator Rockefeller for his great contribution.

And I will conclude this hearing.

[Whereupon, at 1:30 p.m., the subcommittee was adjourned.]

ADDITIONAL ARTICLES, LETTERS, AND STATEMENTS

STATEMENT OF INDEPENDENT TRUCK OWNER-OPERATORS ASSOCIATION

Comes now the Independent Truck Owners-Operators Association (I-TOO), and submits these comments to the Interstate Commerce Commission (I.C.C. or Commission) on the insurance crisis currently affecting the motor carrier industry.

COMMENTOR'S REPRESENTATIVE

Commentor is represented herein by William P. Jackson, Jr., Jackson & Jessup, P.C., Post Office Box 1240, Arlington, VA 22210; (703) 525-4050.

BACKGROUND

By petition filed August 21, 1985, American Trucking Association, Inc. (ATA), requested the Interstate Commerce Commission (I.C.C. or Commission) to investigate the mounting liability insurance problem facing the trucking industry. Dozens of letters from across the country flooded in supporting ATA's request. On October 31, 1985, the Commission instituted the requested investigation. Notice of the proceeding appeared that same day in the I.C.C. Register, establishing a comment deadline of December 2, 1985.

COMMENTOR'S INTEREST

I-TOO is a 5,700-member nationwide organization of owner-operators. I-TOO assists owner-operators in all phases of their business, from providing information about current trends in transportation regulation to providing guidance and assistance in dealing with motor carrier lessees, obtaining and financing equipment, and obtaining insurance. I-TOO is headquartered at 4-6 Porter Street (Route 27), Lower Level, Suite A, Stoughton, Mass. 02072.

SCOPE OF CURRENT INSURANCE PROBLEM

The current insurance crisis affects the entire motor carrier industry, but affects the owner-operator segment of the industry most drastically. Owner-operator remain a critical segment of the industry, providing carriers with efficient and flexible service capacity at a cost which is generally lower than the cost at which carriers could provide the same service with company employees and equipment. Thus, factors which harm owner-operators harm the entire industry.

The nationwide insurance problem affects owner-operators most severely. Owner-operators are small businessmen, usually operating only one or two trucks. A business of this size generally has a relatively low income, making it a relatively undesirable customer for an insurance company. Also, when a company operates only one or two vehicles, insurance rates are higher per vehicle. These facts have always made it more difficult and more expensive for owner-operators to obtain the needed level of insurance than it is for trucking companies to do so. This problem has increased many fold because of the current tight insurance market.

In looking into the insurance crisis for its members, I-TOO has encountered many unjust actions being perpetrated by insurance companies. For example, some insurance companies are refusing to insure drivers who are under 25 years of age or over 65 years of age, despite the fact that Department of Transportation (D.O.T.) regulations allow drivers of interstate motor vehicles to be as young as 21 and older than 65. Another insurance carrier, the Iowa-based Carriers Insurance Company (Carriers), is unjustly refusing to pay claims, despite having been ordered by the Iowa Insurance Commissioner to continue paying claims while being prohibited from writing new coverage or renewing existing coverage. Meanwhile, Carriers is trying to sell off two profitable affiliates.

Arbitrary cancellation of coverage is another problem. One of I-TOO's members inadvertently underpaid his insurance premium of approximately $5,500 by 25 cents. On this pretext the policy was cancelled, although the insurance company has still not notified the involved owner-operator.

Another abuse is unrealistic inflation of values on which insurance is based. For example, Insurance Company of the State of Pennsylvania (ICPa) has decreed that the minimum value which it will accept as a basis for collision insurance on a 1985 Freightliner vehicle is $74,500. However, I-TOO was recently involved in purchasing several such vehicles for association members, and obtained them at $58,500 apiece. With insurance being charged at five and one-half percent of the value of the vehicle, ICPa's arbitrary inflation of the value of the vehicles for underwriting purposes costs the owner-operator an additional $880 per year in premium. Yet, the insurance company will pay claims only based on the actual cash value of the vehicle. In essence, therefore, the insurance company is wringing nearly $1,000 of additional premium out of the insured for no actual increase in insurance.

Many insurance companies are selectively excluding owner-operators based in certain states or those which carry certain commodities from those that they will insure. A number of insurers simply will not write insurance for owner-operators based in particular states in order to avoid being required to provide 30 days' notification prior to cancellation of a policy or being limited on their ability to cancel policies which have already been paid for. Similarly, many owner-operators have been required to agree not to haul electronic equipment, cigarettes, alcohol or chemicals in order to obtain insurance. This type of limited underwriting by insurance companies makes the insurance industry, rather than the I.C.C., the real regulator of what transportation service is provided in interstate commerce.

I-TOO has also become aware that some insurance companies are writing insurance out of line with state-mandated reserves-to-premiums ratios. When this occurs, the insurance companies are subject to actions by the state, including cutbacks in their pool of insureds. These sanctions eventually redound to the detriment of the owner-operator and the motor carrier industry.

The result of these problems is the loss of insurance by many owner-operators. When an owner-operator loses his liability insurance, he is out of business. For most, this means having to surrender their vehicle to the bank which holds the loan on the equipment. This leads to a ruined credit rating and huge debts to the bank when the bank sells the owner-operator's used equipment at a fraction of its actual worth.

CAUSE OF PROBLEM

There have been two major causes of the current crisis—insurance industry mismanagement and virtually unregulated motor carrier entry. Insurance company mismanagement has been a direct cause of the current crisis. In 1982 and 1983, insurance companies substantially readjusted their underwriting criteria in order to attract additional premium dollars for investment at high rates of return. In so doing they accepted many undesirable risks. Many have had increased claims against them as a result. But the problem stems from their acceptance of unadvisable risks, not from any misdeed by the vast majority of those insured. Of course, the increasing trend towards large court awards against carriers involved in accidents has exacerbated this problem. But the major fault lies in the insurance carriers' eagerness in the early 1980's to take vast amounts of premium to be invested at sky-high interest rates.

Another less obvious cause of the problem with the insurance industry has been trouble in the reinsurance market. For example, a major reinsurer of Carriers Insurance Company has filed for protection under the bankruptcy code, reportedly owing Carriers Insurance over $12 million. This type of problem has adversely impacted on the financial stability of the motor carrier insurance industry.

The other major cause of this crisis is this Commission's improper implementation of the Motor Carrier Act of 1980. This Commission, some members of Congress, and many major shippers have fostered an interpretation of the Motor Carrier Act of 1980 which calls for virtual abolition of entry control and absolute freedom to reduce rates. As a result, thousands of new carriers have entered the industry, depressing rates greatly. While this has satisfied many shippers, it has also had the effect of eroding motor carrier safety and greatly increasing the number of claims made against some insurance policies. This, in turn, has forced insurance premiums up while insurer investment income falls, resulting in a great leap in insurance premiums this year. This Commission is directly reponsible for this portion of the insurance problem.

SOLUTIONS TO THE PROBLEM

Insurance is required for interstate operation as a motor carrier. In order to meet the goals established by Congress in the Motor Carrier Act of 1980, the government must make certain that insurance unavailability and high prices do not force carriers and owner-operators out of the market.

In exerting control over the insurance industry, the federal government should do two things. First, it should require that all motor carrier liability insurers not discriminate on the basis of age. Specifically, the government should require that insurers make insurance available for any owner-operator who is qualified under Department of Transportation regulations to operate a motor vehicle in interstate commerce.

Secondly, the government should require insurance companies to accept placements from an assigned risk pool which would be open to carriers which cannot otherwise obtain insurance. The current crisis is the result of insurance company greed and mismanagement in the early 1980's. Having cause the problem, the insurance companies must contribute to its solution. Creation of an assigned risk pool would provide a direct solution to the problem which these companies have created for themselves and the motor carrier industry. While these exist in some states, a uniformity of administration at the federal level is clearly desirable.

CONCLUSION

The current insurance crisis is hitting owner-operators the hardest. They are being discriminated against and victimized by the insurance companies which only two or three years ago were doing everything possible to lure owner-operators to obtain coverage with them. The so-called "Great Insurance Giveaway" of the early 1980's was a result of the insurance industry's mismanagement. The insurance industry therefore must contribute as proposed herein to solving the problem which that giveaway created.

AMERICAN CONSULTING ENGINEERS COUNCIL,
Washington, DC, December 11, 1985.

Hon. LARRY PRESSLER,
Chairman, Subcommittee on Business, Trade and Tourism, Committee on Commerce, Science, and Transportation, U.S. Senate, Washington, DC.

MR. CHAIRMAN: The American Consulting Engineers Council (ACEC), a nationwide federation of over 4,500 engineering firms in private practice representing over 120,000 employees, greatly appreciates the concern you have shown regarding the current crisis in professional liability insurance. Congressional hearings on this critical issue, such as the one you chaired on December 3, are an important way to bring this problem and potential solutions to the attention of key congressional decision makers. We request this letter be included in the hearing record.

Consulting engineering firms, like the rest of the business community, have been severely impacted by the sky-rocketing price of liability insurance and more recently, by the lack of availability of liability insurance at any price. Smaller firms, which make up the bulk of our members, have been particularly hard hit.

ACEC surveyed its member this summer on the insurance issue. The results were quite shocking. The survey shows consulting engineering firms paying an average of 2.87% of their gross billings for liability insurance coverage in 1985. That figure is 14% higher than last year and 23% greater than in 1983. Consulting engineers experienced premium jumps in virtually all types of work, with structural designers' insurance costs leading the pack. They paid 4.5% of billings for insurance, a figure 54% higher than it was in 1983.

Equally distressing, the survey showed that the proportion of firms paying deductibles of $5,000 or less dropped from 33 to 30 percent, while those paying deductibles of $25,000–$100,000 increased from 9 to 11 percent. However, ironic as it may seem, increased claims were not to blame for rising insurance costs. Claims frequency declined from 43 per 100 firms to 39. Firms surveyed also indicated that the outlook for 1986 seems equally grim.

An area of particular concern to ACEC is that of toxic waste and asbestos cleanup. Under current federal legislation, and engineering firm doing the cleanup of a site can be sued, even though that firm did not dispose of the waste. As of January 1, 1986, engineering firms will no longer be able to obtain insurance for any type of pollution related activity, particularly, hazardous wastes and asbestos removal. It is unclear what impact this will have on engineering services which may incidentally

involve toxics, such as water pollution control, drinking water, solid waste management and several other environmental areas mandated by federal law.

ACEC has been working diligently on the hazardous waste issue with appropriate members of Congress as the Superfund legislation progresses. Our goal is to remove response action contractors (engineering and construction firms) from the chain of strict, joint and several liability imposed by Superfund and apply a single standard of negligence to their activities throughout the 50 states. We are also urging that the legislation include a provision requiring EPA to provide discretionary indemnification for response action contractors as a substitute for insurance which is unavailable in the private sector. The House bill (H.R. 2817) includes such provisions; the Senate bill (S. 51) only includes indemnification. We believe both are essential.

ACEC is also engaged in a number of activities to help our member firms deal with the liability problem. We have published a number of guidelines and manuals on this subject and we have founded a Hazardous Waste Action Coalition. The coalition is studying ways for consulting engineering firms to reduce their business risks and to set up supplementary liability contract provisions. It is also reviewing the possibility of establishing an offshore captive liability insurance company.

However, we feel, given the severity of the problem, that industry efforts alone are not enough. Action by Congress and the federal government should be taken to help alleviate the impact of this crisis on the business community. In addition to the reforms already mentioned in the hazardous waste cleanup area, actions such as tort reform, specifically caps on liability awards and reductions in attorneys contingent fees, are needed in order to restore the stability and availability of liability insurance.

Once again, we applaud the leadership you have shown on this issue and offer ACEC's assistance in legislative efforts you may be undertaking in the area of insurance liability.

Sincerely yours,

ARNOLD L. WIDMAN, *President.*

AMERICAN BAR ASSOCIATION,
December 11, 1985.

Hon. LARRY PRESSLER,
Chairman, Subcommittee on Business, Trade and Tourism, Committee on Commerce, Science, and Transportation, U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: It is our understanding that your subcommittee has just concluded hearings on liability insurance with a focus on commercial property and casualty insurance. In connection with those hearings you may be interested in the results of a comprehensive five-year study on the tort liability system prepared by an ABA committee.

In 1979, the ABA's Board of Governors created the Special Committee on the Tort Liability System with a charge to present a "review of the tort liability system" that would focus on: (1) "the present-day validity of the tort liability system in dealing with claims for physical injury," defined to include property damage; (2) "the strengths and weaknesses of the system in today's legal and social environment"; and, (3) "the consideration of appropriate modifications or alternatives to the current system aimed at curing identifiable defects while preserving the recognized strengths."

After five years of study, the Committee produced the enclosed 981-page report entitled "Towards a Jurisprudence of Injury: The Continuing Creation of a System of Substantive Justice in American Tort Law". The views represented in the document have not been considered by our House of Delegates and therefore are not ABA policy but represent only the views of the Special Committee on the Tort Liability System. Also enclosed is a summary of the report.

Publication of the report was followed by two ABA-sponsored conferences on the tort liability system, one in Lexington, Kentucky and one in Washington, D.C. In addition ABA President William W. Falsgraf has recently appointed an Action Commission to Improve the Tort Liability System which expects to make policy recommendations to our House of Delegates in February, 1987. Enclosed is a list of the members of the Action Commission.

The ABA has adopted the enclosed policy on federal product liability legislation. If you would like us to provide you with additional information on this policy, please let me know.

If a legislative proposal in the area of commercial property and casualty insurance is developed, we would appreciate the opportunity to study such a proposal. We would also appreciate it if you would make this letter a part of the record of your hearings.

Sincerely,

ROBERT D. EVANS.

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